

The University of Chicago

CONSUMER-CREDIT THEORIES

A PART OF A DISSERTATION SUBMITTED TO
THE FACULTY OF THE SCHOOL OF BUSINESS
IN CANDIDACY FOR THE DEGREE OF DOCTOR
OF PHILOSOPHY

1942

By
WALLACE P. MORS

Reprinted from
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PREFACE

BEFORE the turn of the century consumer credit, like Topsy, "just grewed." Since then it has been subjected to increasing analysis, until today a considerable body of doctrine exists on each of its major problems. Many controversial points have been raised, and conflicting programs of social action have been suggested. Now needed is a critical synthesis of the analyses of writers in the hope not only of coming to some conclusions on their merits but also of laying a more systematic foundation for further discussion. This work, therefore, concentrates upon theories of consumer credit, covering actual developments and problems of consumer-credit agencies only when necessary in the exposition of ideas.

It is manifestly impossible to discuss the ideas of all who have written. Lack of space has restricted the coverage of even the more serious contributions.¹ No particular attempt has been made to as-

certain who was the first author to enunciate an idea or to outline a given type of analysis. It is rather the general development of ideas surrounding each problem which is of major interest. Because writers have concentrated so largely on instalment repaid credit, although it constitutes less than one-half of the volume of consumer credit, its relation to the field as a whole is considered at some length.

Each of the following chapters covers one key problem. The method of attack is indicated at appropriate points.

I am indebted to Professors Neil H. Jacoby, Garfield V. Cox, and Willard J. Graham and to Mr. Burr Blackburn for critical suggestions and encouragement. My wife has assumed much of the burden of improving the exposition. For any errors which remain I am responsible.

W. P. M.

CHICAGO, ILLINOIS
April 1943

¹ For fuller treatment and documentation of the problems discussed in this study see the writer's "Theories of Consumer Credit" (unpublished Ph.D.

dissertation, School of Business, University of Chicago, 1942). The present monograph is a condensation of part of this dissertation.



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CHAPTER I

CONSUMER CREDIT: THE CONCEPT

A. THE PROBLEM OF DEFINITION

ALTHOUGH various shades of meaning have been given it, the term "credit" basically represents "an advance of goods or services or claims on goods and services in anticipation of repayment at a later date."¹ This definition contains the two essential elements of credit, namely, an advance from one person to another of commodities or claims on them and trust or confidence on the lender's (seller's) part in the borrower's (buyer's) willingness and ability to make whatever repayment is agreed upon, either in commodities or in claims, at some future date. From Colonial times on, especially since the Civil War, more and more credit has taken the form of claims expressed in terms of money, until today virtually all of it falls in this category.

ORTHODOX DEFINITION

The present study is concerned primarily with consumer credit. Frequent reference will be made to producer credit as a means of more sharply delineating both the meaning of consumer credit and its effects on the economy. This procedure has the added merit of justifying and making clear the nature of the producer-consumer credit dichotomy.

A literature has accumulated only in the last forty years. Long before that, starting with the classical economists, in fact, definitions of consumer credit had been suggested and refined down to a more or less standard form. Among

writers on consumer credit there was little disposition to question this form until the works of Professors Plummer and Seligman were published in the respective years 1926 and 1927. Since then, opinion has been more divided.

This standard form of definition, characterized hereafter as orthodox, is stated in terms of the motive of the borrower, that is, the purpose for which the credit is to be used by him. Franklin Ryan sounds the keynote by contrasting "capital borrowed to use in further production" with "borrowed money [used] to buy necessities of life for some personal or family emergency. The former is called a productive loan and the latter a consumer's or consumptive loan."² The implication of the word "emergency" is clear, namely, that with consumptive credit the emphasis is in permitting the borrower use of the "necessaries" sooner than otherwise would be possible. C. R. Noyes puts it somewhat more tersely by saying that producer credit "is used in business for profit," while consumer credit is not.³

Although other variants of the orthodox definition could be cited, the one best adapted to further analysis is the following: "The purpose of consumer credit is to enable the borrower to enjoy his money income before earning it or otherwise receiving it. Any ultimate increase in his money income which may result from stepping up his consumption is

² *Usury and Usury Laws* (Boston: Houghton Mifflin Co., 1924), pp. 8-9.

¹ Rolf Nugent, *Consumer Credit and Economic Stability* (New York: Russell Sage Foundation, 1939), p. 27.

³ "Financing Prosperity on Next Year's Income," *Yale Review*, XVI (January, 1927), 231.

purely incidental.”⁴ This is contrasted with producer credit, the purpose of which is to enable the borrower to increase his money income by an amount greater than the interest he pays. Two discursive comments may be made. In a theoretical equilibrium situation the increased money income resulting from producer credit would equal, not exceed, the interest. Again, under theoretical conditions it is doubtful that even an incidental increase in money income would result from the use of consumer credit.⁵

This definition distinguishes money income from satisfaction or psychic income. It will be argued in chapter ii that the major purpose of the consumer borrower is to increase the satisfaction he obtains from spending a *fixed* level of money income through time. When he borrows in the capacity of a producer, on the other hand, his motive is to increase his command over commodities, that is, the level of his money income in the future. That the result may not correspond to the anticipation is of no particular consequence in this connection.

The definition is cast in terms of the effect of consumer credit on the individual borrower. In this sense later argument will show that no modifying statements need be made. Since borrowers spend the credit advanced to them, the question inevitably arises whether there is any difference between consumer and producer credit in their influence on the money income of society as a whole. If there are no unutilized resources, the definition may be extended intact.⁶ Several writers have maintained that if unutilized resources exist, and if an increase of con-

sumer credit represents an increase in the money purchasing power of the system (i.e., if it reflects an increase in the amount of money and/or in velocity), then it may induce an expansion of money incomes. The word “may” should be emphasized, because, unless the additional consumer credit in turn causes producer credit to rise, it is highly unlikely that the initial increased money incomes due to the consumer credit will be sustained. The reasons for this are fully discussed later.⁷ It is sufficient to say here that even in these special circumstances producer credit bears the more fundamental relationship to augmented money income.

To destroy the orthodox definition once for all, it would be necessary to show its inapplicability in an economy marked by full employment. To point to the need of its modification under conditions of less than full employment (and with expansion credit⁸ present) is not sufficient;⁹ in fact, the modification can be understood only by starting from the simpler set of circumstances. Neither is it enough to point out in specific instances the impossibility of drawing the line between producer and consumer goods and, consequently, between the two analogous types of credit. This difficulty is inherent in the application of any broad concept to concrete cases. Many writers have

⁷ See chap. iv.

⁸ The term “expansion credit” refers essentially to the $M'V'$ of the well-known equation $MV + M'V' = PT$. In rare cases V might behave in such a way as to create expansion credit.

⁹ With full employment, substantially the same conclusions are in order whether expansion credit exists or not. Therefore, only the full-employment condition need be specified. With underemployment, however, consumer credit is potentially capable of expanding money incomes only if the additional condition of expansion credit exists. Therefore, whenever the latter type of situation is under discussion, two requisites exist.

⁴ Charles O. Hardy (ed.), *Consumer Credit and Its Uses* (New York: Prentice-Hall, Inc., 1938), p. 3.

⁵ See chaps. ii and iii.

⁶ See chap. iii.

noted the point, but only a few have been incautious enough to advance it as a major justification for abandoning the dichotomy.¹⁰

Historical developments and their relation to the problem of definition.—Certain writers, mainly those who confine themselves to instalment-sales credit, have made more serious efforts to refute the orthodox definition, and they warrant greater attention. The heart of their position consists in the assertion that no essential differences exist between production and consumption and hence between producer and consumer credit. Such a claim cannot be substantiated by merely setting up a definition. It is the task of the following three chapters to show by argument that the orthodox definition is on the whole legitimate. Most of the criticisms leveled against it are there evaluated. However, certain of them can most conveniently be dealt with here. It is the contention of the writer that the historical circumstances under which claims and counterclaims were born do not necessarily affect their ultimate truth or falsity. That must be determined by theoretical reasoning, and it is with the latter that this study is concerned. Nevertheless, a knowledge of these historical circumstances enriches one's understanding of the course which arguments have taken and may prevent overharsh judgment of their advocates. This is especially true of consumer credit, since a considerable segment of the field has had the misfortune of developing and being written about in the midst of community skepticism anent its social desirability and usefulness. Critics of the orthodox definition, with all that it im-

plies, have been markedly influenced by this skepticism.

Cash lending dates back to the Middle Ages, a period dominated by deficit consumption credit. Its emergency nature and the close group feeling of the period condemned any interest charge. The pressure of business lending in the seventeenth century forced the enactment of permissive laws with fixed maximum rates. Greater opportunities for producer loans, with the shift of thinking from the group to the individual following the Reformation, encouraged the doctrine of thrift and wealth accumulation. Negatively stated, the contention was that frugality obviated the need of consumption loans to cover contingencies.

Unfortunately, perhaps, there was a need for consumer loans, and, more unfortunately, most of them, because of their small size and high risk, could not profitably be made under maximum rate or usury laws. Community unwillingness to provide higher rates is a reflection of two contradictory tendencies: the community's belief that consumer borrowing is unnecessary and its older antagonism to borrower exploitation in those cases where such borrowing was unavoidable.

With the coming of the industrial revolution, the demand for consumer loans increased. Borrowers were often in a "necessitous" condition; since banks would not accommodate them, they turned to lenders, newly come into being to meet the demand, who did not scruple to take advantage of them. This generalization should not be pushed too far, since these lenders assumed added risks in trying to circumvent the usury laws. The unfavorable situation did engender abuses and, paradoxically enough, aggravated the already skeptical attitude of the community toward consumer lend-

¹⁰ See Harvey W. Huegy, "An Economic Analysis of Instalment Credit" (unpublished Ph.D. dissertation, Department of Economics, University of Illinois, 1934), p. 28.

ing. It is this stage (the post-Civil War period in the United States) which brought forth a reform movement and a literature. Before considering these developments, the very different history of sales credit may be traced briefly.

Traditionally, sales credit has been looked upon as convenience rather than emergency credit and has been extended in the main only for one income period. In a real sense it has not been considered credit at all but rather a briefly deferred cash sale. This, plus a remarkable freedom from abuses, accounts for the much healthier community attitude which has existed toward (lump-sum, open-account, or income-period) sales credit. With the advent of the industrial revolution, and particularly since World War I, the emphasis has been shifting more and more to long-term sales credit, extended usually on the instalment plan and increasingly to lower-income groups. The longer period has served to emphasize the twofold nature of credit selling, namely, the sale of a commodity and the extension of credit. When abuses accumulated in the later decades of the nineteenth century, they were associated with that aspect deemed most responsible, namely, extension of credit. There resulted an adverse community attitude, younger and not so deeply entrenched as in the case of cash credit, but still adverse. In the meantime income-period sales credit has undergone little change and is still without stigma.¹¹

Classical economists gave greater precision to certain ideas on consumer credit. Since they did not mention sales credit (they wrote before instalment selling became important), it is presumed

that their remarks were directed mainly at consumer cash lending. This strengthens the generalization already made that, until instalment-sales credit developed, sales credit was not considered credit in any real sense. However, there is little doubt that the classical writers, if specifically asked, would have extended their conclusions to cover sales credit. While not condemning all consumer credit, they did speak of it disparagingly, since it did not increase a nation's wealth and income and, even worse, competed with producer credit which did. This attitude was aggravated by their tacit acceptance of the argument that everyone could and should save. Unlike the community, they were consistent in advocating the repeal of the usury laws and so making possible consumer cash lending on a legal basis. Neoclassical and other modern economists have not given much attention to consumer credit and have for the most part reiterated classical conclusions.

The extension, after the Civil War, of consumer cash lending to the lower-income groups took place under conditions long adverse and against a well-entrenched hostile intellectual background. The progress of instalment-sales credit, on the contrary, was not initially so encumbered. Unfortunately, because the bulk of the post-Civil War users were of the low-income groups (immigrants and Negroes), and because sellers were not always overscrupulous, this extension of instalment-sales credit soon manufactured sufficient abuses to arouse unfavorable community reaction. Although not capable of proof, it seems likely that the age-old antagonism to consumer cash lending, and the growing (explicit) realization that (instalment-)sales credit is a form of credit, transferred to sales credit much of the stigma attached to cash credit. As of, say, 1900, then, only open-

¹¹ For more detailed treatment of developments in the United States see the writer's "Theories of Consumer Credit" (unpublished Ph.D. dissertation, School of Business, University of Chicago, 1942), chap. ii; see also n. 12 below.

account sales credit and cash loans to the upper-income groups had escaped censure.¹²

Effect of historical developments on consumer-credit literature.—Consumer-credit literature, influenced by historical developments, falls into two main groups—that concerned with small cash loans and that interested in instalment-sales credit. The former has been accumulating since about 1909; the latter, from the early 1920's. With a few notable exceptions, open-account or income-period sales credit has received little or no attention. The cash-loan literature is directed mainly at loans to the lower-income groups. Nevertheless, many of its conclusions may be extended to all consumer loans.

Writers on cash lending have had one main objective—convincing the community that a real need for such loans exists and that the only way to meet this need is to replace the usury laws with high-rate legislation. In the way have been two major obstacles: “first, the influence of the vicious and second [and more fundamental], the ignorance of the virtuous.”¹³ The first refers to the opposition

of illegal lenders to reforms which would deprive them of their usually very profitable business. The second, already emphasized, represents the adverse community attitude toward consumer borrowing coupled with the insistence that what borrowing is done be carried on at usury rates—rates too low to be commercially feasible. If space permitted, many examples of this confusion could be given.

Because of their concentration on reforms, writers on cash lending have provided only an undercurrent of theoretical analysis. Except for a few books and articles covering consumer credit as a whole, the bulk of the theoretical analysis has come from works on instalment-sales credit. The latter began accumulating in the early 1920's as a direct outgrowth of the phenomenal postwar growth of selling on instalment. In this field no handicapping legislation existed. There was, however, a backlog of abuses built up from instalment practices of the preceding three or four decades. Many writers, quick to point out these abuses, made dire predictions for the future and suggested the need of reforms. Others took the opposite position and attempted to show by analysis that the abuses were overrated and that reforms were unnecessary.

The presence of abuses and, more fundamental, the rebellion of a thrift-minded community against what it regarded as wholesale excursion into debt (debt associated with “extravagant or wasteful” expenditures) put the writers who opposed reforms on the defensive. Extravagant claims and counterclaims resulted, and there was a flood of propa-

¹² One of my critics argues that only in recent decades has open-account sales credit been extended to the lower-income groups. According to him, the results of this extension parallel the results of the earlier analogous extension of instalment-sales credit, namely, abuses and an unhealthy community attitude. The abuses, he believes, are somewhat concealed, owing to the fact that the embarrassment of debtors does not become known until they have recourse to cash loans. He concludes that the statement in the text to which this footnote is appended, should, in so far as open-account sales credit is concerned, be expressly restricted to the period before, say, 1900. Several comments are in order. Certain instalment-sales credit abuses, such as tricky contract provisions and price misstatement, have no counterparts in the open-account sales credit sphere. More important for a study concerned primarily with ideas, neither the community nor writers on consumer credit have seemed aware of the alleged abuses of open-account sales credit. This is evidenced by the lack of any reform movement and by the paucity of writing on the subject.

¹³ R. B. Fosdick, “Discussion of Remedial Loans,” *Proceedings of the Academy of Political Science in the City of New York*, II (January, 1912), 171.

ganda in the worst sense of the term. The sharpness of the controversy did bring forth more serious efforts, and out of them have come respectable analyses on most of the theoretical problems attaching to instalment-sales credit. The conclusions reached and their applicability to other types of consumer credit will be considered separately for each problem to be discussed.

The orthodox definition and the social usefulness of consumer credit.—It may be recalled that the classical economists tended to identify increase of wealth and income with social usefulness. Producer credit—defined as credit which permits an increased income to the borrower—tends to become identified per se with social usefulness. By inference, consumer credit is not. The argument that social usefulness is an invalid criterion has not been encountered and may be dismissed without serious consideration. More fruitful is the denial that social usefulness is limited to that credit which permits augmented money income. This is the position taken by most of those writers on consumer credit who adhere to the orthodox definition. As one of them puts it, "the justification of consumer credit lies in allowing consumers to consume when they want to consume rather than in increasing their total possible consumption."¹⁴ This point of view is elaborated in succeeding chapters.

Critics of the orthodox definition.—An alternative approach admits that social usefulness is linked only with credit permitting an increase in money income and argues that consumer credit permits such an increase. If this view is taken, a new definition of consumer credit becomes im-

perative. Actually its proponents have been content for the most part to destroy the orthodox definition. Seligman, the pacemaker here, starts with the proposition that there is little difference between production and consumption if they are correctly interpreted. The former is "that creation and accumulation of material goods which will *at the same time permit of . . . the development of that immaterial wealth* which we call social welfare," or, again, as that creation which, by rendering a "surplus of utilities over costs" to its creator, adds to his welfare.¹⁵ He interprets consumption as the using-up of the utilities inherent in wealth in such a way as to add to the user's welfare, that is, to give him a surplus of utilities over the cost of obtaining them. Where this surplus is not realized, the production or consumption, as the case may be, is wasteful or destructive.

Since production and consumption deal with the relation of man to wealth and since each involves a surplus of utilities over costs, there is little distinction between them. Both are parts of a larger whole—utilization.¹⁶ Seligman leaves no doubt of the relation of his discussion of definition to the question of the social usefulness of consumer credit:

The inference to be drawn is that there is no longer any foundation for the opposition so often voiced against consumption credit, based on the idea that it represents something destructive, as over against production credit, which represents something creative. . . . Consumption credit is quite as legitimate as production credit.¹⁷

An interesting side light on Seligman's desire to remove all doubts of the legiti-

¹⁴ Roy Westerfield, "Effect of Consumer Credit on the Business Cycle," *Annals of the American Academy of Political and Social Science*, CXCVI (March, 1938), 106; see also Hardy (ed.), *op. cit.*, p. 144.

¹⁵ Edwin R. A. Seligman, *Economics of Instalment Selling* (New York: Harper & Bros., 1927), I, 160, 163. (Italics mine.) Seligman's definition seems to take no account of the rendering of direct labor services, unless labor be counted as wealth.

¹⁶ *Ibid.*, p. 164.

¹⁷ *Ibid.*, pp. 174-75.

macy of consumer credit is his attitude on the use of terms. Before he wrote, "consumer," "consumption," and "consumptive" (their correlatives are "producer," "production," and "productive") were used more or less interchangeably. In deleting the term "consumptive," he set a precedent which most subsequent writers have been content to follow. His argument was partly economic and partly psychological. Economically, as already indicated, he was interested in showing that all credit increases the economy of human effort, and therefore psychologically he objected to the medical connotation of wasting-away attaching to the term "consumptive," saying there is nothing of this in the institution of credit. He preferred the words "consumption" or "consumer" and expressly used them interchangeably throughout his work.

A more serious problem of terminology may be cleared up at this point. The term "consumption" ("consumptive," too, for that matter) is not unambiguous, being used to mean severally the using-up of utilities inherent in commodities, the enjoyment of these utilities, and the delivery of commodities into the hands of consumers. The last meaning is convenient as far as credit for consumption purposes is concerned. "Consumer credit is used universally either to finance the purchase of consumers goods and services or to refinance debts that had their origin in such purchases."¹⁸ To elaborate, credit is advanced at the time a commodity is sold, whether or not the utilities in it are used up and enjoyed in full at that particular time. Loans to refinance already existing debts are covered, though less

obviously, by the preceding sentence. The greater the durability of the commodities bought on credit, the greater, other things being equal, will be the divergence between their delivery and the rate at which they are used up and/or enjoyed. In order to avoid confusion, Nugent adopts the adjective "consumer" to describe credit used in financing of the purchase of consumers' commodities and reserves the terms "consumption" and "consumptive" to cover the using-up of the utilities in them. This seems a sensible procedure.

Seligman's position is open to several objections. Of a purely logical nature is the point that if his attempt to destroy the distinction between production and consumption be judged successful, then, in discrediting the orthodox definition, he has obviated the need of any definition of consumer credit. All that seems necessary is to define the more general term "credit." The very fact that his two-volume work is dedicated to the topic of instalment selling, which, according to him, is a part of consumer credit, virtually vitiates his position. Second, by arguing that both production and consumption lead to a surplus of utilities over cost, he in effect counts the same utilities twice. *Reductio ad absurdum*, it implies that a mere bringing into being of a commodity results in utility to the producer even if it is never used up. Conversely, the allegation that production by itself can yield an excess of utilities over cost seems to be an admission that it can be thought of independently (i.e., that there is a difference between production and consumption). Professor Knight has shown that, under conditions present in the economic systems of the Western world, capital must be regarded as perpetual; there is no using-up of a given capital quantity unless society as a

¹⁸ Nugent, *op. cit.*, p. 31.

whole is disinvesting.¹⁹ Production can exist without consumption, and a distinction must be made between them.

The most vulnerable weakness of Seligman's position lies in his failure to comprehend the true nature of production and consumption. Opposed to him is a long line of economists who accept the dichotomy. They do so because, although they recognize that, "from a teleological point of view, [both] have the same end—economic welfare—[they] are quite different in essence and action, in so far as production aims at the creation of the sources of satisfaction by external and objective activity, while consumption is the process, individual and subjective, by which the results of economic activity merge into the immeasurable psychic consciousness of the individual."²⁰ The allocation of resources among alternative uses offers different problems from the allocation of money income among commodities.²¹

Seligman's discussion may, therefore, be censured on several grounds: (1) its failure to abolish the legitimacy of the production-consumption distinction; (2) its failure to offer an alternative definition of consumer credit; and (3) its confusion resulting from the attempt to read social usefulness per se into the concept of (consumer) credit. In addition, he is largely responsible for providing a pseudo-scientific basis for the extravagant claims later made (he himself is not innocent) on behalf of consumer (especially instalment-sales) credit. Although

popular writers furnish the preponderance of the material here, academicians are not lacking. As they do not add anything new to the issue at hand, they warrant no specific mention at this point.

Rolf Nugent's analysis of the problem of definition is interesting in relation to the two divergent points of view previously developed. He starts with the unequivocal orthodox statements that "the principal distinctions between producer, public, and consumer credit arise from differences in their motivation rather than from differences in the uses to which the credit is put" and that "consumer credit is motivated by desire for satisfactions from the present use of goods and services." This contrasts with producer credit, which is "motivated by anticipation of business profits."²²

Then come qualifications: "In some respects the above distinctions . . . are less significant than differences in the uses to which credit may be put within each of these groups of credit recipients."²³ Within each group credit may be used to "acquire useful assets or finance deficits, and this distinction is obviously of prime importance."²⁴ Then, turning to the contention that consumer credit is not productive, since its use contributes nothing to the facilities for producing commodities (his definition in terms of motives has already admitted this), he says:

That there are significant differences between the kinds of goods which are likely to result from the use of credit by business enterprises and by consumers is undeniable. But it is impossible to establish any clear cut relationship between these kinds of goods and their social usefulness. . . . The fact that household capital goods are used to supply family satisfactions while pro-

¹⁹ Frank H. Knight, "The Quantity of Capital and the Rate of Interest," *Journal of Political Economy*, XLIV (August, 1936), 450-63.

²⁰ N. R. Danielian, "Theory of Consumers' Credit," *American Economic Review*, XIX (September, 1929), 394.

²¹ Frank H. Knight, "Notes on Utility and Cost" (Department of Economics, University of Chicago, 1935), pp. 2-6. (Mimeographed.)

²² *Op. cit.*, pp. 29-30.

²³ *Ibid.*, p. 30.

²⁴ *Ibid.*, p. 30.

ducer capital goods are used to yield a profit distinguishes their motivation but not their social usefulness.²⁵

Two points emerge, one clear, the other not. The former is Nugent's insistence (1) that the principal definition of consumer credit runs in terms of motivation or purpose and (2) that a definition in such terms does not carry any implication as to the social usefulness of such credit. This clearly fits what has been labeled the "orthodox view." If anything, he makes more explicit the fact that the definition as such carries no connotation, one way or the other, on social usefulness.

The point which is not clear concerns the relation of consumer credit and productivity. His principal distinction between consumer and producer credit in terms of motivation implies that consumer credit does not add to the facility for producing goods. Yet he insists that in some respect the uses to which credit is put within each of the producer- and consumer-credit groups are of prime importance. By a series of rhetorical questions²⁶ he implies that some uses within each group may lead to greater productivity and some may not. His statement that some producer credit is consumptive (he defines consumptive credit as credit used to finance deficits) sheds no light on the discussion. By it he refers to the fact that some producer credit is advanced to help tide companies over a period of crisis. This merely reflects the fact that the credit previously advanced did not turn out as anticipated. The motive is unchanged both in the original grant and in the emergency one; it is merely not realized in the former and may not be in the latter.

In the last analysis he seems unwilling

to accept the orthodox definition in full. Yet in a later chapter, in discussing consumer credit under conditions of full employment of resources, he admits that consumer credit cannot add to its users' incomes or to that of society. His major preoccupation is with conditions of unemployment, and it has already been admitted that in such circumstances consumer credit may, if it results in an expansion of producer credit, augment the economy's real income. Perhaps this is the reason for his unwillingness to accept unequivocally the orthodox definition. Thus his position on definition is not entirely clear.

Succeeding analysis shows to be untenable the extreme statement that consumer-credit users are those "who buy and use money or goods in such a manner, or under such circumstances, and according to such means as may impair their moral and economic efficiency."²⁷

NEED OF A TANGIBLE STANDARD FOR CONTROL PURPOSES

Economic analysis is not an end in itself but a means toward intelligent social action. Both in analysis and in framing public policy quantitative data are often helpful. While for purposes of analysis, the distinction between producer and consumer credit in terms of motive or purpose "is accurate and important, it cannot be used rigidly for the discussion of practical problems. Consumer credit cannot be completely isolated from producer credit either for statistical measurement or for purposes of control."²⁸ For practical problems "loans must be classified by a more tangible standard."²⁹ A more desirable way of stating the issue

²⁷ Homer O. Stone, "What Indiana Has Found," *Personal Finance News*, XX (November, 1935), 10.

²⁸ Hardy (ed.), *op. cit.*, p. 10.

²⁹ *Ibid.*

²⁵ *Ibid.*, p. 32.

²⁶ *Ibid.*, pp. 32-33.

is to say that it is difficult to collect raw credit data by purpose. But, once collected by some other standard, the data may be broken down into percentages of producer and consumer credit. This is facilitated by the fact that, although "no complete segregation of consumer credit is possible . . . by a classification of credit granting agencies, . . . fortunately these agencies tend to specialize in credit granting to consumers on the one hand or to producers on the other."³⁰

Commercial banks represent the major exception, but, fortunately, a growing number have separate departments for "consumer" loans. In an earlier article Nugent went so far as to declare that it was best to define consumer credit entirely in terms of agencies.³¹ This extreme view cannot be maintained. The position set forth in the previous paragraph is corroborated by most of the statistical studies which have been made. Whether they cover all "consumer" credit-granting agencies or only those which extend credit repayable in instalments, they estimate the respective portions of consumer and producer credit in the total credit granted.

It is usually not feasible to frame one public policy for the producer credit granted by an agency and another for the consumer credit. Nevertheless, intelligent policy for the agency as a whole demands knowledge of these respective amounts. Professor Westerfield's comment is appropriate here. Having accepted the orthodox distinction between producer and consumer credit, he goes on:

³⁰ Nugent, *op. cit.*, p. 35.

³¹ "Consumer Debt and the Business Cycle," in *Financing the Consumer*, ed. John H. Cover ("Journal of Business Studies in Business Administration," Vol. VII, No. 4 [Chicago: University of Chicago Press, 1937]), pp. 1-2.

It is necessary to remember that merely because a loan is small, is of short term, is a co-maker loan, or is paid by partial payments or small or irregular amounts, does not put it in the category of consumer credit. Nor does the fact that a loan is made by the personal loan department of a bank, by an industrial bank, or by a licensed lender put it into the consumer credit group.³²

Some of the foregoing represent producer credit, and, therefore, "it is not only wrong from a practical and social point of view to put such loans with consumer credits, but it is utterly confusing in economic theory."³³

Writers on consumer credit usually exclude loans of savings banks, building and loan associations, and insurance companies to depositors, members, and policy-holders, respectively, on the grounds that these loans do not represent credit in the real sense of the term, since the borrower is getting back previous savings. Real estate mortgage loans are excluded for other reasons. Some writers have called attention to the point that, because some type of shelter is necessary, mortgage credit may be considered as a substitute for the otherwise necessary expenditure on rent. No precise analogy is said to exist in the credit purchase of other types of goods by consumers. Others have noted that in many cases mortgage credit partakes of the nature of producer credit. Actually, a good case can be made for including all mortgage credit extended against family dwelling facilities in the consumer-credit category. A final difference resides in the much longer maturity characteristic of mortgage credit.

To a few writers, the problems arising "in connection with home financing are so different from those involved in other forms of consumer finance that they . . .

³² *Op. cit.*, p. 99.

³³ *Ibid.*

constitute a distinct study."³⁴ A second point of view, given more precise statement at the close of our next chapter, is that many of the conclusions on consumer credit apply also to mortgage credit. Because this study is primarily a critique of the literature, it has been thought wise to follow the general practice of not including mortgage credit in the discussion. Farm credit is excluded on similar grounds.

One writer suggests that, logically, consumer credit "should be taken to mean 'household debt position'—allowing both for cash and receivables owned and for all short-term and long-term debts owed."³⁵ This broad definition of consumer credit comprises (1) debts included in the narrower (orthodox) definition of consumer credit adopted in this study; (2) all investment assets owned by consumers; and (3) the following types of consumer debts: rents, taxes, and the obligations mentioned in the two paragraphs above. There is no denying that consumer decisions with respect to the categories excluded by the "orthodox" definition are important in their effects on the economy. In fact, figures tend to show that consumer decisions with respect to these excluded categories were quantitatively more important during the depression of 1930-33 than consumer-credit changes in the more narrowly defined sense of this study. All that need be said here is that the problems associated with consumer credit in its "orthodox" meaning are sufficiently peculiar and at the same time important enough to warrant special treatment. At least, study of consumer credit in its "orthodox" sense should provide valuable

groundwork for anyone interested in studying consumer credit in the broader sense suggested by Professor Hart.

Although there is general agreement that the agency standard is best adapted to the collection of raw data, several writers have made alternative suggestions. One would define consumption as the elimination of commodities from the business system or the sphere in which the calculus of money costs and money returns applies. The opposite of consumer credit becomes not producer credit but business credit.³⁶ Statistically speaking, this suggestion of Kuznets offers certain difficulties. Raw data must still be collected by agencies. Once this is done, they must be reclassified, and the question arises whether the reclassification should conform to his proposal or to the orthodox one in terms of motive.

Neither is easy. Credit grantors are often no more in a position to judge whether or not credit will remove a commodity from the business system than to determine the purpose for which it is to be used. Further, many commodities are removed from the cash nexus only to reappear at a later date: witness the used-car market and the secondhand markets in general. Kuznets' suggestion, moreover, contains a serious theoretical objection. The limits of business and credit are not set by the presence or absence of money. Carried to its logical extreme, his definition would eliminate business credit entirely in a barter economy and all credit would be consumer credit. But this would be false to the facts. In an economy such as the one we now have his position does have a certain validity and is, in fact, not too far different from the orthodox one. This should not mis-

³⁴ Hardy (ed.), *op. cit.*, p. 11.

³⁵ Albert Gailord Hart, review of Rolf Nugent's *Consumer Credit and Economic Stability*, in *Journal of Political Economy*, XLIX (February, 1941), 129.

³⁶ Solomon Kuznets, "Statistics of Consumer Credit" (manuscript, 1934), pp. 3-5. (Mimeographed.)

lead one into abandoning the latter, however.

Of an entirely different nature is the suggestion that the term "consumer credit" should be interpreted in a technical rather than a descriptive sense. It would include (1) loans which do not compete with commercial bank loans, (2) loans payable in instalments, and (3) loans which are high in cost and hence high priced.³⁷ The statistical difficulties of this proposal are serious. The first and third criteria would be hard to evaluate in the case of specific loans. More fatal, the second one excludes over two-thirds of the sales credit and about one-half of the cash credit granted to consumers. The usefulness and theoretical validity of the proposal have yet to be demonstrated.

SUMMARY

The preceding analysis has set forth the nature of the orthodox definition of consumer credit and has examined certain of the criticisms leveled against it. There still remains the task of showing by positive argument that it is correct under conditions of full employment and needs modification only under those of underemployment and then not as much as is usually supposed. This task will be undertaken in the three chapters following. By indicating the real nature of consumer credit, these chapters also provide a means of evaluating conflicting ideas on its social usefulness.

B. ON THE UNITY OF THE FIELD

Consumer borrowers have in a broad sense a similar purpose in borrowing. "All forms of consumer credit arise directly or indirectly out of the sale of

goods and services."³⁸ There is an essential unity to the field. This does not preclude setting up certain classifications for analytical purposes. Although two are appropriate, writers—Nugent excepted—have explicitly employed only one. Out of a discussion of the nature and sphere of applicability of the first classification will emerge those of the second as well.

SALES-CASH CREDIT DICHOTOMY

The primary classification has two parts. Probably of earliest origin, one long formalized by law, is the part which distinguishes sales and cash credit. Also old but particularly apparent in recent decades is the part built around the method of repayment, lump-sum versus instalment. The two parts cut across each other. Of the first, one writer poses the rhetorical question: "In terms of *economic function* what is the conceivable difference between the two methods [the loan of money and the credit sale of a thing]?"³⁹ Or, positively, the buyer on the instalment (or open-account) plan is "merely borrowing money in the form of goods."⁴⁰

The position of the above writers (many others in similar vein could be cited) is clear. Not always so clear are the underlying assumptions. Perhaps of major importance is the supposition that consumers are under no compulsion in their choice of either type of credit. Less necessary but highly desirable is the existence of a sufficiently over-all free market so that borrowers can switch back

³⁸ Nugent, *Consumer Credit and Economic Stability*, p. 41.

³⁹ Reginald Heber Smith, "Rethinking Usury Laws," *Annals of the American Academy of Political and Social Science*, CXCVI (March, 1938), 190.

⁴⁰ W. S. Lagerquist, "What Does Instalment Buying Cost the Consumer?" *System*, I (September, 1926), 257.

³⁷ M. M. Grobбен, *What Is Consumer Credit?* (New York: Consumer Credit Institute of America, Inc., 1936).

and forth from sales to cash credit as relative prices (interest rates) warrant. Given these conditions (it is the author's contention that writers cited have them implicitly or explicitly in mind), consumers will go through similar calculations with either type of credit, and, when once extended, both types of credit will have similar effects on production and on the economic system. Strictly speaking, and this is the crux of the argument, compulsion is more completely absent in credit the use of which is anticipated by the borrower, for then he will have the greatest potential freedom of choice not only whether or not to borrow but also in shopping around once he has decided to borrow. For the theoretical analyses in the following chapters the important distinction is between anticipated and unanticipated and not between sales and cash credit. Nugent's classification recognizes this. His income period and capital financing represent "short-term" and "long-term" anticipated credit, and his deficit financing comprises "long-term" unanticipated credit. Under theoretical conditions the latter would be absent.

Historically, unanticipated or emergency credit has existed. Furthermore, it has been associated primarily with cash lending. The reform groups obtained legislative reforms in the small-loan field after 1910 by emphasizing the fact that the necessitous condition of many (not all) cash borrowers made them susceptible to lender exploitation. Writers on instalment credit have stressed the voluntary nature of sales credit, claiming that its users are fully capable of looking after their own interests. Of course, neither generalization is wholly correct, but both are sufficiently so to have influenced legislative trends. This is evidenced by the presence of price regulation in the cash-loan field and its

absence in that of sales credit. The sales-cash credit classification is the proper one in a discussion of rate regulation⁴¹ as well as in a historical analysis of the factors underlying the growth of consumer credit.⁴²

DISTINCTION BETWEEN CREDIT PAYABLE IN ONE SUM AND IN INSTALMENTS

The more serious attempts at analysis fall into two classes, arguing either that the instalment method of repayment necessitates no special analysis or that it introduces problems *additional to* and not *instead of*⁴³ those associated with credit payable in a lump sum. The latter seems to represent the dominant view; those who adopt it emphasize that these additional problems arise not from the instalment method per se but from the particular historical circumstances surrounding its use.

Seligman, the first to deal at length with the problem, notes that "instalment credit is to be differentiated from other forms of credit in that it represents fractional or piecemeal or periodical liquidation as over against lump-sum liquidation."⁴⁴ Instalment credit is, however, a part of consumer credit as a whole, and, therefore, "what is true of all forms of consumers' credit must be true of instalment credit as well."⁴⁵ But instalment credit may present "additional or special problems over against the general problems involved in consumers' credit."⁴⁶ And then comes a very signifi-

⁴¹ See the writer's "Rate Regulation in the Field of Consumer Credit," *Journal of Business*, Vol. XVI (January and April, 1943).

⁴² This problem is covered in the writer's "Consumer Credit Theories," chap. ii.

⁴³ These terms have been appropriated from Westerfield, *op. cit.*, p. 100. His position is similar to Seligman's; its nature is brought out in what follows.

⁴⁴ *Op. cit.*, I, 139.

⁴⁵ *Ibid.*, p. 142.

⁴⁶ *Ibid.*

cant statement: "It happens that in *practical life* these additional problems are of great importance, and that they in some respects overshadow the problems common to all forms of consumers' credit."⁴⁷ These additional problems arise from the "character of the commodities" usually associated with the instalment method and "the conditions affecting their use."

In expansion of the phrase "character of the commodities" Seligman points out that consumer credit is utilized in connection with all types of commodities, tangible and intangible. Since instalment-sales credit is a part of consumer credit, it, too, could be extended to permit the purchase of all types of commodities. Such has not been the case in practice, for instalment-sales credit has been limited in the main to durable and, as a rule, relatively high-priced commodities. Less important is the point that many of these commodities are relatively new.

By "conditions affecting their use" Seligman refers to the fact that the durable and high-price characteristics of commodities usually associated with the instalment method require that the size of the credit granted be greater than in the case of ordinary consumers' credit and that it be extended for a longer period of time. The phrase "ordinary consumers' credit," it may be presumed, means open-account sales credit which is usually, though not invariably, liquidated in a lump sum. The only defensible standard from which to measure the length of the credit period is the income period of the borrower. There has been a historical tendency for instalment credit, both sales and cash, to extend beyond

the user's income period and for open-account sales credit to be income-period credit.

The larger the size and the longer the time to maturity, the greater, other things being equal, will be the risk of non-payment. This risk is met by two characteristics of the instalment method, one inherent, the other, historically at least, inseparable. The latter refers to the tendency of sellers to reserve the right of repossession and "is the outstanding feature of instalment credit which distinguishes it from other kinds of consumers' credit."⁴⁸ The inherent characteristic is, of course, the method of piecemeal repayments, which permits periodic liquidation of the debt and avoids the necessity of the lender's (seller's) waiting until the end of the credit period for repayment.

Professor Huegy rightly extends Seligman's analysis to include instalment-cash credit, but, in so doing, he falls into a trap from which in a certain sense Seligman himself does not escape. He justifies the extension by saying that both instalment-cash and instalment-sales credit represent the attempt of consumers to get utilities which would otherwise have to be deferred because of the lack of the full purchase price of the commodities desired.⁴⁹ This ignores the patent fact, already alluded to earlier in the chapter and which he tries to refute, that some proportion, probably a substantial one, of instalment-cash credit is used to finance deficits, for example, unforeseen expenditures of an involuntary sort. A portion of instalment-sales credit, probably negligible, falls into a similar category. Strictly speaking, the problems attaching to instalment credit "in

⁴⁷ *Ibid.* (Italics mine.) The use of the term "practical" is very important (see pp. 15-16 below for further discussion).

⁴⁸ *Ibid.*, p. 204.

⁴⁹ *Op. cit.*, Vol. I, chap. i.

addition to" those attaching to lump-sum credit apply exclusively to those parts of both types of credit which represent anticipated credit. Only Nugent in his latest work, devoted primarily to cycle analysis, explicitly recognizes this.

What are the "additional problems" brought about by the historical association of (anticipated) instalment credit with durable, high-priced commodities or, more fundamentally, with relatively large-sized, beyond-the-income-period credit?⁵⁰ From the consumer user's point of view the fact that instalment credit permits him to use the commodity while or before paying for it necessitates particularly close attention to the effect of the instalment credit on his spending-saving pattern, his enjoyment of a given money income, and his ability to increase his money income. Each of these points is elaborated in the following chapter.

From the point of view of the economic system it becomes pertinent to ask: Does the instalment method permit the more effective use of resources? Has it influenced the total demand for products and/or the relative demand for particular ones? Because of the association of instalment credit with durable goods, what is its relation to the capital problem? Durable commodities being more sensitive cyclically than nondurables, is the instalment method affecting or affected by the cycle in any peculiar way? These points are discussed in chapters iii and iv.

One writer explicitly takes the stand that no distinction of the above sort need be made. In his words:

⁵⁰ "Accommodation" loans of banks, to some extent at least, are used for the purchase of durable goods. As previously remarked, the instalment-lump-sum distinction is less sharp in the cash than in the sales-credit field. The statement in the text is not changed by this fact, but to it must mentally be added the point just made.

Consumers' credit, as understood in this paper, includes only credit that has a contractual basis. It is mainly in the form of instalment credit. However, the conclusions of subsequent discussion hold true of all kinds of consumers' credit.⁵¹

A good part of his article centers around the topics found in chapters xii-xiv of Seligman's work—chapters in which Seligman claims he is discussing those "additional problems," largely of a "practical" nature, which attach to the instalment part (more strictly the anticipated, beyond-the-income-period part) of the field of consumer credit.

This contradiction, apparent or real, has not been touched upon in the literature. Perhaps it has been overlooked or perhaps it is another illustration of one weakness in this field, namely, the failure of writers to make direct criticisms of others' analyses. This aberration is second only to their frequent failure to make as clear as might be desired the specific assumptions underlying their various arguments.

It is the belief of the writer that a reconciliation of these diverse views can be made and that it hinges on differences authors assign to the terms "theoretical" and "practical." Under theoretical assumptions of knowledge, rationality, and individual autonomy of action, that position seems correct which denies that any economic distinctions are introduced by the instalment method of repayment. Under theoretical conditions the total amount of credit granted by a lender (seller) would be a function of the borrower's (buyer's) ability to repay. Given the total length of the credit period (it is automatically included in the concept of the "amount of credit" but is singled out for emphasis) and interest at the going rate on the balance outstanding, the

⁵¹ Danielian, *op. cit.*, p. 394.

problem of repayment would be a matter of indifference to those extending credit. Or, from the borrower's point of view, the handling of his budget would in no wise be changed by the method of repayment. Assuming that the maturity of the debt extends beyond his income period, the borrower would, if the debt were repayable in instalments, pay the appropriate amount, including interest, each income period; if, however, the debt were repayable in a lump sum, the borrower would build up his bank balance each income period at a rate sufficient to liquidate the debt at maturity. The drain on the borrower's income in each income period being the same in either case, the method of repayment would have no effect on his spending-saving pattern. The interest which the borrower receives on his growing bank balance in the lump-sum case is offset by the falling interest with each succeeding payment in the instalment case. The net result is the same. In this situation only pure interest is involved, since collection and risk costs would be reduced to zero.

Therefore, in theory, neither the total amount of credit outstanding in the system nor the spending-saving behavior of the borrowers is affected by the method of debt repayment. It should be added that in a strict theoretical (incremental) sense all credit extends beyond the borrower's income period. In the actual world, however, a substantial amount of credit is extended and repaid within one income period. This need cause no change in the conclusions thus far reached. For purposes of analysis one could imagine instalment payments within an income period as well as one lump-sum payment at the end of it.

Does this mean that the point of view represented by Seligman and others is wrong? Referring to the quotation

above,⁵² it is the present author's contention that Seligman uses the term "practical" in two senses. In its first sense the term "practical" represents an implicit dropping of one or more of the assumptions underlying theoretical analysis. This is illustrated by the large number of writers who take sides on the question of whether or not the instalment method permits the average consumer to be more or less rational in spending his money and in deciding how much to save and how much to spend. Pure theory could not admit a mere technique of repayment as an influence on the fundamental question of choice among present goods and/or between present and future goods.

In its second and more important sense the term "practical" has a historical connotation. The preceding discussion has emphasized that historically the instalment method has been associated in the sales-credit field with durable, high-priced commodities.⁵³ In the cash-credit field less has been said on the point, but in the main instalment-cash credit is the result of unforeseen emergency expenditures or of the purchase of goods costing more than the borrower can pay from his current period's income. From the above has followed the historical association of the instalment method with credit relatively large in amount and extending over several income periods.⁵⁴ In contrast, lump-sum sales credit traditionally has matured within a given income period, and the average credit extension has been, as a rule, much smaller in

⁵² See p. 14 and n. 47.

⁵³ Recently there has been a considerable application of the method to "soft goods." This reinforces the point, if it needs reinforcing, that no theoretical distinction can be made between the maturity and size of the credit and the method of repayment.

⁵⁴ See n. 50 above in this connection.

amount. As used in this study the concept "size of credit" is relative and has as its base of comparison the income the credit user receives each income period.

An analogy to the theoretical-historical distinction here set up is afforded by the classical theory of distribution. It is usually given a certain validity as an interpretation of conditions existing in the later eighteenth and early nineteenth centuries, but it is regarded as inadequate from the point of view of pure theory.

SUMMARY

In conclusion, the theoretical analyses in succeeding chapters are built around the distinction between unanticipated (deficit) and anticipated credit. Anticipated credit receives the preponderance of attention and for historical reasons is subdivided into income-period and beyond-the-income-period (capital) credit.

In considering the problem of credit control, the sales-cash credit dichotomy is appropriate. The sales-cash credit dichotomy is also useful in discussing the problem of rate regulation and in evaluating the factors underlying historical growth, subjects not covered in this study.

It should be noted that the two classifications have more than superficial resemblance. Income-period, capital, and deficit credit, to use Nugent's convenient terms, roughly coincide with open-account, instalment-sales, and cash credit. This is particularly true in terms of origins, less so of present-day conditions, since a growing amount of cash credit is of the anticipated variety. The important difference between them is one of emphasis, that is, each makes for the greatest clarity of analysis in its respective sphere(s).

CHAPTER II

THE EFFECT OF CONSUMER CREDIT ON THE CONSUMER

THE major objective of the present chapter is to examine critically a subject much discussed in the literature, namely, the nature of the influence which consumer credit exerts on consumers in their attempts to manage intelligently their earning-spending-saving programs. Consumer credit may also indirectly affect consumers' earnings, and, in turn, their spendings and savings, by altering conditions external to them, such as the size of production units, the state of technology, and the supply and allocation of the factors of production. Particularly powerful here are consumer-credit movements based on bank-de-

posit expansion. These important indirect effects are fully considered in the two chapters which follow. Here only the direct effects are discussed; to expedite matters, external conditions are assumed given and unchangeable except to the extent that they are altered by consumers in their decisions with respect to the use of consumer credit. In particular the existence of bank (expansion) credit is denied. Speaking more broadly, money is presumed to be neutral and its function limited to that of facilitating exchange without, at the same time, exercising any influence on what is exchanged or on the ratios of exchange. The temer-

ity of this assumption is realized, but it is defensible on analytical grounds.

Writers have had a tendency to make sweeping claims pro and con on each of the major problems to be discussed. In some cases these exaggerations stem from a failure to realize the nature and limitations of a priori economic reasoning and/or a misapplication of statistical data in the support of economic reasoning; in others, from a failure to set forth clearly the assumptions underlying the discussion and/or a failure to define carefully the terms used. This chapter not only examines various writers' analyses of the problems but, in addition, indicates clearly for each how far a priori economic analysis, given a clear definition of terms and an explicit statement of underlying assumptions, can profitably be extended. It is the view of the writer that many authors exaggerate what can be expected of such analysis in this sphere. However, what can be said is of great importance.

A. THE RELATION OF CONSUMER CREDIT TO THE MAXIMIZATION OF PSYCHIC INCOME

ANTICIPATED CREDIT

Discussion of the effect which anticipated consumer credit has on the maximization of the psychic income of its users inevitably revolves around the influence of such credit on their consumption. It is analytically convenient to recognize that this maximization may be either quantitative or qualitative. In other words, greater satisfaction may mean "more in actual amount" or "better in the sense of higher grade," a refinement of consumption, so to speak.

Quantitative maximization of satisfaction under theoretical conditions.—The question involved here is largely that of

the choice between present and future utilities. The usual assumptions of theoretical analysis, namely, knowledge, rationality, and a free market, are in order. It is also assumed that all commodities are available in small enough units to permit every consumer to choose as much or as little of each as he wishes in his next income period. Under these conditions each consumer, after having decided how much of his money income he wishes to spend, is free to allocate this amount in any proportion among the various commodities, since all are equally available. If income were received continuously and in small increments, there would be no lapse between receiving and spending. Under these simplified conditions the only conceivable function of credit would be to permit individuals to live beyond their income for a time. This would be possible, granted the existence of psychological variations among persons in their attitude toward saving and spending.¹ The question arises: What effect does the use of credit by some consumers have on their satisfaction? A similar question may be asked concerning those who extend credit.

Presumably, satisfaction will be increased all around, since those individuals with greater impatience believe they will achieve greater satisfaction by consuming more now and less later, and vice versa for those with lesser impatience. Otherwise there would be no borrowing or lending. As Irving Fisher has so well argued, under these conditions the vary-

¹ Even under the artificial conditions assumed here, economists usually make a distinction between psychological variations among individuals and the rationality of behavior on the part of individuals. Since this level of analysis deals with robots rather than with persons (i.e., biological considerations are seemingly pushed aside), it would seem equally valid to argue that the rationality assumption would dictate the absence of psychological variations among individuals.

ing degrees of human impatience would set the price of credit.² The interest rate would come to rest at that level which would equate the preferences of the marginal borrower(s) and marginal lender(s). Axiomatically, the market would be cleared. It is readily perceivable that under these conditions the commodities as such exercise no influence. All are available in small enough units to allow the consumers to take as much of each as they wish in any given income period. Therefore, consumers are free to revise their estimates anew each income period on the basis of current funds available for consumption.

Interest could conceivably vary widely from negative to positive rates, depending upon whether preferences for future satisfaction outweigh preferences for present satisfaction or whether the reverse is true. If productive investment were introduced into the discussion and if, as is true of the world we know, productive investment dominates, then negative interest is ruled out by the fact that interest rates are determined largely by considerations of the marginal productivity of capital. Under the conditions assumed here it is idle to speculate on the amount of savings at any one time or on the trend of savings through time. The tendency to save would probably be weakened considerably in the absence of productive investment, for such investment, through its expanding effect on money incomes, is a powerful factor in making saving possible on the part of those who are psychologically so inclined. Net shifts for society between saving and dissaving would, as already noted, be definite possibilities. Such shifts, it should be pointed out, would, in the absence of productive investment,

have no effect on the size of society's real national income.

Under the conditions assumed here, the allocation of resources and the imputation of income to resources proceeds continuously and in (infinitely) small increments. Therefore, all credit extends beyond borrowers' income periods.³ A closer approach to reality may be made by assuming that income is received periodically, usually weekly or monthly. This introduces the possibility of income-period credit which would come into existence in so far as some individuals might wish to buy throughout their income period and pay at the end of it. As in the case of beyond-the-income-period credit, for income-period credit to be possible, some members of the community must be willing to save. The conclusion previously reached to the effect that credit will permit an increase in consumer satisfaction is equally applicable here. Thus no sharp distinction need be made between income-period and beyond-the-income-period credit or between lump-sum and instalment credit.

In the period of repayment the borrower will reduce his consumption relative to what it would have been had he not borrowed. This will not result in lessened satisfaction through time if his calculation of present versus future satisfaction at the time of borrowing turns out to be correct. Given rationality and the absence of uncertainty and sales pressure, there is no reason to doubt accuracy of calculation.

One peculiarity attaching to the pres-

³ In the strict sense there could be no credit under these very artificial conditions, since consumption would also proceed continuously and in (infinitely) small increments. Only with finite increments would lending and borrowing be possible, for only then could there be commodities in the physical sense of the word. The procedure adopted in the text should be regarded as a convenient analytical device.

² *The Theory of Interest* (New York: Macmillan Co., 1930), chap. v.

ent discussion emanates from the assumed absence of durable commodities. They vary in durability but, in general, have a life extending over more than one income period. Where all commodities are consumed each income period, borrowers do not have to estimate at the time of purchase how much satisfaction they would get from a given commodity in future income periods. In other words, consumption in any one income period is independent of that in future income periods so far as the choice among commodities is concerned. The only link between present and future is the necessity of determining whether it is desirable to spend more now or later. The introduction of durable commodities offers an added complication; the consumer must decide not only on his relative total consumption now compared to the future but also on whether he believes those durable commodities chosen now will, in future income periods, yield as much satisfaction as nondurable commodities would if purchased at those points in the future. Although distinguishable analytically, both calculations are part of the general process of comparing present and future satisfaction. Buying durable commodities does not necessarily increase present consumption, since all the commodity cannot be consumed in a given income period. It is impossible to measure in any real sense whether present consumption is more or less in this case than it would have been in the absence of the durable commodity, but it is possible to conceive of such a measure for analytical purposes. The distinction is made more necessary by the fact that the literature has given the preponderance of its attention to the relation of consumer credit to the choice between durable and ephemeral commodities.

The introduction of durable commod-

ities, then, complicates matters. For one thing, rationality is best realized when all commodities are bought continuously.⁴ More to the point here is the fact that anticipated credit may influence the choice among commodities, whereas in the absence of durability such was not the case. This is not to say that credit is the cause of bringing durables into being. Strictly, this influence applies to all durables, but for practical purposes only those which are high-priced relative to the money income a consumer earns each income period need be included in the discussion. Unless an individual decides to forgo entirely the consumption of (high-priced) durable commodities, two possibilities are open to him: he may reduce his consumption of ephemeral commodities and save until he has accumulated enough money to buy durable commodities or he may continue his purchases of ephemeral commodities at almost the usual rate and buy durable commodities at the same time by promising to pay for them at a later date. If he decides to borrow, he will have to reduce his consumption of ephemeral commodities each income period by a sum which will enable him to set aside an amount sufficient to extinguish the debt at its maturity. Included here is interest, if any. A third possibility, that of renting the durable for the time desired, is not of enough importance to warrant its inclusion in the discussion.⁵

If consumers followed the first alternative, anticipated credit (except to permit adjustments of total consumption among income periods) would not exist. In this case no problems in addition to those al-

⁴ Frank H. Knight, "Notes on Utility and Cost" (Department of Economics, University of Chicago, 1935), pp. 6-8. (Mimeographed.)

⁵ Cf. G. Schwartz, "Instalment Finance: The Nature of Consumer Credit," *Economica*, III (May, 1936), 190-95.

ready discussed would be encountered, and further discussion would be superfluous. It is in connection with the second alternative that Seligman, the first writer to discuss the problem extensively, asks: "[1] Does instalment credit make possible the present enjoyment of goods which otherwise could not be obtained until the future, and, [2] if so, is this an advantage to the consumer?"⁶

To digress briefly, a few explanatory remarks are advisable. Seligman limits his analysis to instalment-sales credit and stresses the historical relation of this type of credit to durable commodities. As emphasized in chapter i, he points out that, although instalment-sales credit is part of consumer credit and has the latter's characteristics, at the same time certain "practical additional" problems attach to instalment-sales credit because of its historical association with durables. Implicit in his analysis is the distinction made in chapter i and at the outset of the present chapter between theoretical and actual (historical) conditions. The point is further strengthened by the fact that Seligman explicitly discusses the effect on his (theoretical) conclusions of withdrawing the assumption of rationality. Therefore, the present discussion, although necessarily adhering to his terminology in discussing his work, argues that his conclusions apply to anticipated credit generally.

Seligman answers the first question in the above citation by the statement that (anticipated) credit places durable commodities on a par with ephemeral commodities.⁷ He notes that the instalment method, by rendering possible fractional price units, permits consumers to buy

high-priced, durable commodities and to pay for them while they are being consumed. The instalment method brings somewhat nearer the "ideal of the satisfaction coming at the same time as the earning of the income."⁸ Given theoretical conditions, the same assertion holds for lump-sum credit. Upon examination the idea expressed in the citation proves to be part of the broader question of the effect of anticipated credit on consumer satisfaction; the closer juxtaposition of earning and satisfaction can be justified only in so far as satisfaction is thereby increased. This broader question is now under examination.

Seligman comes more directly to the point in the statement that those who use instalment-sales credit to buy durable commodities "are subtracting from present enjoyments for the sake of storing up future utilities."⁹ He supports this rather obvious remark by a long analysis in which he claims that payment usually precedes utilization. He argues that the use value of the commodity to the consumer falls less rapidly than the resale value. Dealers are interested only in resale value and therefore require a high enough down payment and a short enough credit period to insure that the article is still usable after being paid for. "Instalment credit . . . is in this respect [the sacrifice of present for future utilities] more like cash payment than like credit payable in a lump sum."¹⁰ This somewhat misleading statement is based on the unrealistic assumption that it is unnecessary with lump-sum credit to provide for repayment until the debt is finally due. On the contrary, the receiver of lump-sum credit, like the re-

⁶ Edwin R. A. Seligman, *Economics of Instalment Selling* (New York: Harper & Bros., 1927), I, 260.

⁷ *Ibid.*

⁸ *Ibid.*, p. 257. Authors by the score have echoed this quotation.

⁹ *Ibid.*, p. 256.

¹⁰ *Ibid.*

ceiver of instalment credit, must provide periodically for repayment and so sacrifice present for future enjoyment. The comparison of instalment-credit and cash purchases is unwarranted, since with cash purchases no diminution in currently bought consumption will be necessary during future income periods.

Whether credit provides an advantageous service in making durable goods available earlier than otherwise would be possible depends, according to Seligman, on (1) the cost of the credit, (2) the rate of discounting the future, and (3) the comparison of present and future satisfaction. The last condition is clearly irrelevant, since, as he should have recognized, this is the problem to be answered, the first two conditions being the determinants of the relative size of present and future satisfaction. In fact, he implicitly recognizes this with respect to the cost factor but not with respect to the "rate of discounting the future."

Seligman assumes that "competition among those that afford the service will bring the cost down to a point where it is worth while."¹¹ Several comments are in order. It is clear that Seligman is thinking of present-day conditions in the United States—conditions in which large amounts of savings have been built up and put at the disposal of institutionalized lenders, who then attempt to extend credit at the highest rates possible. Hence his reliance on competition to lower rates. Of importance for purposes of theoretical analysis is the necessity of abstracting from such lenders (or at the least of assuming that they exist but have no effect on loan rates except for administrative costs) and of assuming that the interest rate (cost) will measure both marginal lenders' and marginal borrow-

ers' preferences for present relative to future utilities.¹²

This statement (Danielian seems to overlook the point) is valid only under conditions which abstract from producer credit. For where, as in our society, producer credit exercises a preponderant influence on the demand for savings (indirectly on their supply as well) the interest rate is set by considerations of marginal productivity.¹³ Producer borrowers are not concerned with present versus future satisfactions. Consumer borrowers are, but their calculations have little or no effect on the interest rate (cost), and so they take that as a parameter. Seligman, whether aware of it or not, is justified in introducing the cost factor, because he seems to take producer credit into account in his analysis.

If, on the contrary, producer credit is assumed away, the cost factor merges into the second factor set forth by Seligman, namely, the rate of discounting the future. Cost (interest rate) in this case is determined by the interaction of persons (borrowers) who prefer the present to the future, on the one hand, and persons (lenders) who prefer the future to the present, on the other. Since uncertainty is absent, liquidity preference is zero, and all the savings which come into being will, given competitive conditions, be taken off the market by consumer borrowers. To draw the discussion together, whether, under present assumptions, credit is advantageous in making durable goods available earlier than otherwise would be possible depends on the

¹² N. R. Danielian, "Theory of Consumers' Credit," *American Economic Review*, XIX (September, 1929), 395.

¹³ Frank H. Knight, "The Quantity of Capital and the Rate of Interest," *Journal of Political Economy*, August, 1936, pp. 433-63, and October, 1936, pp. 612-42.

¹¹ *Ibid.*, p. 251.

rate at which persons discount the future.

Seligman notes that the rate of discounting the future "varies, as do all personal valuations, from person to person."¹⁴ Because, he continues, the rate of discounting the future is subjective and is not measurable in money terms, whether or not an individual thinks it desirable to use or to forgo consumer credit must be left to his own judgment. The decision must be made at the time the credit is available, that is, at the time of the purchase of the commodity and not later. Persons using anticipated (instalment) credit evidently think it advantageous at the time. "That some of them change their minds later is true . . . of all purchases, whether for credit or for cash, and has no special bearing on the point at issue."¹⁵

Seligman's conclusion is that, given effective competition and rationality (he later considers whether consumers actually behave rationally), the availability of credit permits those consumers who do not wish to save ahead to buy durable commodities and so to add to their satisfaction through time. At the same time it is clear from his analysis that those consumers who prefer savings are enabled to get interest on their loans and so to add to their satisfaction through time. Given theoretical conditions, this represents the writer's own conclusions.¹⁶

Danielian takes sharp issue; he specifically states that, although concerned mainly with instalment-sales credit, his

conclusions may be extended to (anticipated) consumer credit in general.¹⁷ The following passage sets forth his position:

Consumption credit may increase economic welfare by maximizing satisfactions in the ideal or static economic conditions where the contract is entered into by the free choice of the consumer, in full knowledge of his own present and future financial circumstances and of the conditions surrounding the credit extension, without underestimating disutilities, or overestimating satisfactions. . . . In actual fact, however, consumers are motivated by the same desire when they enter into an instalment contract, but the conditions surrounding the transaction vitiate, partially or totally, this desire to maximize their satisfaction by availing themselves of credit facilities.¹⁸

Because he mentions selling pressure at one point, it is not entirely clear whether he has actual or theoretical conditions in mind. Theoretical conditions are assumed to be the right choice both because of the high theoretical level of most of his article and because of his choice of title. His lack of clearness must be charged against him. The key point in the quotation is the phrase "surrounding conditions." This phrase refers to the two advantages Seligman claims for instalment (anticipated) credit, namely, (1) it places durable goods on a par with ephemeral goods and (2) goods so bought are "saved" income. Only the first point has been touched upon previously; the second point is discussed in the following chapter. Of importance here is the fact that both points are similar in that they depend on the commodities' being durable in the sense of lasting at least through, in most cases longer than, the user's income period.

It is these two advantages, according to Danielian, which contribute to the irrationality of a consumer's choices and

¹⁴ *Op. cit.*, I, 252.

¹⁵ *Ibid.*

¹⁶ For an analysis closely patterned after Seligman's see Harvey W. Huegy, "An Economic Analysis of Instalment Credit" (unpublished Ph.D. dissertation, Department of Economics, University of Illinois, 1937), pp. 53 ff.

¹⁷ *Op. cit.*, p. 394.

¹⁸ *Ibid.*, p. 399.

diminish his "net satisfactions to [1] perhaps less than would be realized if the same commodity were bought for cash, and [2] also to less than he expected at the time of purchase."¹⁹ Only the first point is a relevant standard for comparison. Even if it be provisionally granted that the consumer realizes less satisfaction than he anticipated, if the amount realized is greater than could have been obtained from a cash purchase, the credit has been beneficial. Danielian has introduced a superfluous standard. The gist of his supporting argument hinges around consumer psychology and may be summarized in a paragraph.²⁰

Time is an important element in a credit purchase and enters in three ways: the time of purchase, the period of utilization, and the payment period. In a credit purchase the consumer compares future utilities, those of the durable good with those which will have to be abandoned in the periods of repayment. The future utilities of the durable commodity are likely to be more vividly perceived than those of the commodities the purchase of which will have to be forgone in the future, and the discrepancy becomes greater the smaller the down payment and the longer the period of repayment. This will not happen with cash purchases of durables because there the comparison is between future utilities, this time properly discounted. To make matters worse, buyers on credit tend to underestimate the future disutilities which consist of the "real costs (fatigue, etc.) involved in earning an income and, in a certain sense, of the sacrifices of other utilities that could be bought with the same expenditure."²¹ This happens because buyers cannot see more desirable

alternative ways of spending in the future. In fine:

If the consumer bought a durable commodity on cash, the fruition of the future utilities into present satisfactions as time goes on would create a surplus of satisfactions over and above what he anticipated. As he buys on credit, however, he discounts the future disutilities as well as the future utilities. This eliminates a great part of the potential surplus.²²

Two major criticisms are in order. In the first place, the point on real costs is valid only in a Crusoe economy.²³ Credit would be absent there, of course. In an exchange economy persons do not compare the disutility of working with the satisfaction of buying one as against another commodity. Rather they choose those occupations which give them the greatest net advantages, monetary and nonmonetary, and then spend the money received in such a manner as to maximize satisfaction. To validate his position, Danielian would have to show that the manner (including time shape) of spending money income has some influence on the disutility of earning it and, in turn, on the spending itself. This he does not attempt except to say that future costs are underestimated because the consumer cannot foresee the possibilities of more desirable alternative ways of spending in the future—a statement which tacitly corroborates the point just made, since it tries to connect real costs with the satisfaction from alternative methods of spending. The assertion that persons cannot think of enough ways to spend money, whether in the present or in the future, surely runs counter to experience. Only for persons with unlimited

²² *Ibid.*, p. 397.

²³ For the complications, even in a Crusoe economy, of Danielian's position see A. C. Pigou, *Economics of Stationary States* (London: Macmillan & Co., 1935), chap. viii.

¹⁹ *Ibid.*, p. 396.

²⁰ *Ibid.*, pp. 396–97.

²¹ *Ibid.*, p. 396.

incomes, and they are virtually absent in our world, would the assertion be accurate.

The real issue, then, involves a comparison of (1) the utilities to be expected from the durable commodity in any given future income period plus the utilities to be expected from it in still more future income periods (the number will be governed by its life-expectancy) all properly discounted, if they are discounted, with (2) the utilities which could have been realized in the same given future income period by the diversion of that part of the income used to pay the "durable commodity debt" to other commodities. It makes no essential difference whether the payments exceed, equal, or fall behind the rate at which the durable commodity is being consumed (used up). That part of the comparison indicated under (1) is governed by the life-expectancy of the durable commodity and will be unchanged regardless of the number of payment periods. The number of periods included in part (2) of the comparison will, of course, vary with the number of payments. The borrower will adjust his calculations accordingly. More fundamentally, the borrower will, at the time of incurring the debt, schedule his payments (build up his cash balance toward repayment) in the optimum manner. Only under such highly theoretical conditions that even credit is assumed away will earning (spending) and consuming (using up) coincide. Once credit is granted existence, whether its repayment should or should not coincide with using up the commodity so bought is but a part of the broader question of the effect of such credit on consumer satisfaction. The writer sees no validity in such statements as, "Theoretically the resale value [of the commodity bought] ought never to fall below the total of the unpaid in-

stalments,"²⁴ or to the assertion that consumers should not have to pay for their utilities before they are consumed.²⁵

The second and more devastating criticism of Danielian's analysis lies not in his reasoning but in the assumptions on which that reasoning is based. Given his psychological assumption that persons normally tend to underestimate the future, then obviously his conclusions follow. It may be recalled that this is one of the elements in the interest (capital) theory of Böhm-Bawerk. It hardly needs mention that the foregoing discussion of the effect of consumer credit on consumer satisfaction is at the same time a discussion of interest theory under conditions in which only consumer credit exists. The interest-theory approach has been well worked out by Professor Fisher and others; this, plus the fact that the literature on consumer credit has stressed the satisfaction side, has dictated the alternative approach of the present chapter.

Returning to the point, a good argument can be made and authorities cited to the effect that Danielian's psychological assumption is not warranted. Fisher's development of his interest theory is of significance here; especially the first of his three approximations in which the assumptions are similar to those of the present discussion. They are (1) no uncertainty, (2) a fixed income stream for each individual, (3) competitive conditions, (4) free access to market, and (5) limitation of modifying future income to consumer borrowing or lending. Under these conditions he shows that lending and borrowing will go on in such a way as

²⁴ Albert Haring, "Instalment Selling of Durable Goods," *Journal of Marketing*, II (April, 1938), 280.

²⁵ Stuart P. Meech, "Economic Aspects of Instalment Selling," *Journal of Business of the University of Chicago*, I (January, 1928), 74.

to equate the marginal degrees of impatience of all those in the market with the market rate of interest, that is, "each individual exchanges present against future income, or *vice versa*, at the market rate of interest up to the point of *maximum total desirability* of the forms of income available to him."²⁶ What each individual does "depends both upon the characteristics of his expected income stream, and on his own personal characteristics. The rate of impatience which corresponds to a specific income stream will not be the same for everybody."²⁷ It varies among individuals, owing to differences in foresight, self-control, habit, expectation of life, concern for the lives of other persons, and fashion. Another writer says that consumers wish to "secure as pleasurable a stream of consciousness as possible" and, in so doing, fall into those who enjoy saving over spending, those who prefer to live almost entirely in the present, those who are never quite happy unless in debt, and those who avoid debt like poison. He does not know how many fall into each class, but his main point is that people vary and therefore are affected differently by borrowing and lending.²⁸ "Time preference may not always be a preference for present over future goods; it may under certain conditions be the opposite. Impatience may be and sometimes is negative."²⁹

Professor Knight is, if possible, more explicit:

²⁶ Fisher, *op. cit.*, p. 122 and, in general, chap. v.

²⁷ *Ibid.*, pp. 80-81.

²⁸ Avar L. Bishop, "Social and Economic Aspects of Instalment Buying," in *Financing the Consumer*, ed. John H. Cover ("Journal of Business Studies in Business Administration," Vol. VII, No. 4 [Chicago: University of Chicago Press, 1937]), p. 17.

²⁹ Fisher, *op. cit.*, p. 67.

There is no reason to assume that, other things equal, normal human psychology contains any general tendency to underestimate the future, and it is easy to argue for the predominance of the opposite irrationality. It is impossible to know whether the interest rate would be positive or negative in the absence of opportunity for productive investment. . . . It is true I do not want to wait until tomorrow or next year for today's or this year's rations; but no more do I want to enjoy today or this year the consumption belonging to the more remote interval.³⁰

To argue that persons consistently underestimate the future leads to the conclusion, *reductio ad absurdum*, that no one wishes to borrow and that everyone wishes to lend. Given personal differences among individuals, the conclusion seems reasonable that some will be borrowers and others will be lenders; and, in the process of borrowing and lending, satisfaction through time will be maximized for each individual in spending his money income. The conclusion is strengthened if the assumption of fixed money income through time is dropped. Thus under the theoretical conditions assumed to this point anticipated consumer credit adds to consumer satisfaction. Under such conditions economic analysis rests on a sound foundation, and the resulting conclusions are unequivocal.

If producer credit is introduced into the analysis, the meaning of a stationary economy becomes more complex. In this case and in that of a theoretical progressive economy, if, as is historically true, producer credit dominates, then negative rates of interest are ruled out and consumer borrowers must be willing to pay the minimum interest rate set by considerations of marginal productivity of capital. However, the major conclusion already reached would remain un-

³⁰ "The Quantity of Capital and the Rate of Interest," *op. cit.*, p. 436.

changed. To save space, we make the somewhat abrupt jump to actual conditions in the discussion which follows.

Quantitative maximization of satisfaction under actual conditions.—The question arises: What is the effect on the above conclusion of relaxing the assumptions concerning knowledge (uncertainty), rationality, and a free market? Two points of a digressive nature may be made at once. First, it is at some such lower level of abstraction as this that most writers have vented their spleen on the subject of instalment-sales credit. Second, economic analysis at this level can no longer, in the nature of the case, be as nicely definitive in its conclusions. In removing the assumptions above noted, it is also expedient to drop that of fixed incomes.

The lack of perfect knowledge of the future, that is, the presence of uncertainty in the real world, brings up for discussion two points, one historical, the other more or less theoretical. The former, already discussed in our first chapter, refers to the changes which have been taking place in the consumer-credit field since the later decades of the nineteenth century. It was then that the demand for beyond-the-income-period credit started on a secular upward trend. By itself this meant an increase in the uncertainty of repayment, since the chance of contingencies happening to the borrower increases with the length of the credit period. Uncertainty was further increased because much of the growing demand came from the lower-income groups, which, because they had for the most part never before been eligible for credit, were unknown quantities as risks.

This uncertainty evidenced itself in recourse by lenders to (1) elaborate credit investigation methods and (2) strin-

gent collection devices. These collection devices include the requirement that the borrower place a lien on his property in favor of the lender, the lien to be exercised in event of nonpayment, and the further stipulation that the borrower pay the debt in instalments, thereby enabling the lender to become aware of collection difficulties soon enough to make fruitful use of the lien. Uncertainty of repayment, then, is the primary factor in the elaborate investigation and collection methods used by those extending beyond-the-income-period credit. It accounts for the historical association of the instalment method with this type of credit. This confirms the procedure outlined in chapter i of limiting the discussion of actual conditions to (anticipated) instalment credit.

Uncertainty combined with the technical fact that the average consumer instalment loan is relatively small makes the cost of consumer instalment loans much higher than that of most producer loans. This is true regardless of whether producer loans are repayable in instalments or in one payment. These facts support the generalization that, even given competitive conditions, the price of consumer instalment credit will still be high.³¹ Further, the price of consumer instalment loans will be much higher than it would be under conditions abstracting from uncertainty, since then investigation and collection costs would be near or at the vanishing point. Presumably, these costs will reduce the number of consumers who are willing to borrow.

The other and more theoretical question concerns the effect of uncertainty on the comparison of present and future satisfaction. All that can be said is that there is no more reason for assuming that it will cause greater weight to be given to

³¹ Danielian, *op. cit.*, p. 396.

present satisfaction than for assuming the reverse. The uncertainty, which includes uncertainty as to future income, will cause some persons to be more solicitous of their future than ever. Others will be willing to let the future take care of itself. This is at bottom a question of psychology and hence one in which economic analysis is no better than the assumptions on which it builds. Until psychology becomes more definitive on the point, the position taken here seems to be the most realistic. Therefore, on this score alone there seems no reason to change the theoretical conclusion already reached. One small difference lies in the fact that, with uncertainty, the interest rate will tend to rise as the credit period lengthens, whereas such was not the case under conditions abstracting from it.

There has been a sharp divergence of opinion in the literature as to whether or not consumers are rational in their use of instalment-sales credit. Extremely pessimistic are those writers who claim that, owing to the ease of obtaining instalment-sales credit, consumers buy those commodities available on credit and forgo more important commodities which are not so available. The result, these writers continue, may be diminution of total utility through time.³² Other writers take the opposite point of view and use the relation of instalment-sales credit and high-priced commodities as the basis for the observation that with such commodities consumers tend to weigh alternatives more closely.³³ Statistical data are

³² James E. Moffatt, "Is Instalment Selling a Boon or a Menace?" *Bankers Magazine*, CXII (February, 1926), 226; James Couzens, "The Question of Instalments," *Industrial Digest*, V (October, 1926), 49; and Roger Babson, *The Folly of Instalment Buying* (New York: Frederick A. Stokes Co., 1938), pp. 60-69. Many other more or less popular articles could be cited.

³³ Frank Parker, "Rationalization of Consumer Credit," *Personal Finance News*, XVI (July, 1931),

of little use in deciding a question of this type.³⁴

The writer does not pretend to be able to settle the controversy once for all. To argue for the complete absence of rationality and still retain hope for a free-enterprise economy is absurd. Neither is it necessary that everyone be a perfect calculating mechanism to make such an economy workable. That people vary in rationality is inescapable.³⁵ It seems reasonable to assume also that unwise spending was not unknown before the growth of instalment-sales credit to its present proportions. As Professor Haberler shrewdly observes, some persons lack the will-power to save, whereas others cannot resist the temptation to buy on credit but would resist paying the entire price at the time of the sale. The former may later be glad they used the credit; the latter may not.³⁶ There are probably many persons who estimate carefully when buying on credit and who find their expectations have been realized more or less fully upon completion of the payments. It is impossible to carry out the equimarginal principle perfectly except where commodities are divisible into small units. Wicksteed suggests that this is why a person feels that he would be

4-7; *ibid.*, August, 1931, pp. 4-7; and *ibid.*, October, 1931, pp. 21-24. Also see any of the numerous articles written by Milan V. Ayres.

³⁴ Wilbur C. Plummer and Ralph Young, *Sales Finance Companies and Their Credit Practices* (New York: National Bureau of Economic Research, 1940), pp. 100-103. For an extreme example see Julian Weiss, "Instalment Selling: A Critical View," *Harvard Business Review*, XVII (autumn, 1938), 98.

³⁵ See the frontispiece quotation in Frederick Macauley, *Some Theoretical Problems Suggested by the Movements of Interest Rates, Bond Yields and Stock Prices in the United States since 1856* (New York: National Bureau of Economic Research, 1938).

³⁶ Gottfried Haberler, *Consumer Instalment Credit and Economic Fluctuations* (New York: National Bureau of Economic Research, 1942), p. 43.

much better off with a little more money, no matter how much he already has. On large-unit expenditures a person tends to spend somewhat more than is justified by his present income. But, if he realized a greater money income, the process would repeat itself.³⁷

That the growth of instalment-sales credit has resulted in consumers' getting more satisfaction from their spending than they would have in its absence cannot be asserted dogmatically. Recalling the fact that this growth has been largely a natural process, one not foisted on consumers, would lend strength to such a position.³⁸ Writers holding otherwise must make out a good argument to the effect that instalment-sales credit, *of itself*, is causing an increase in irrational spending sufficiently strong to bring a breakdown in important spheres of the economy. From the viewpoint of control it is much more important to give consumers an opportunity to exercise an intelligent choice in buying commodities by enforcing more effective competitive conditions throughout the instalment field than to regiment their use of credit

on the grounds that all of them are not fully rational.

To this end three reforms are desirable. The first—uniform and clear rate statement—has been fully discussed elsewhere by the writer.³⁹ The second—the abolition of misleading advertising—is part of the broader program of the promotion of truthfulness in all types of advertising. The 1938 amendments to the Federal Trade Commission Act are a step in the right direction. In the consumer-credit field the order of the Federal Trade Commission prohibiting automobile finance companies from advertising that a 6 per cent discount method of charge represents an actual charge of 6 per cent is illustrative of what can be accomplished. The third—standardization through legislation of contract forms—will reduce the number of variables consumers have to weigh and will permit them to give greater attention to price. One writer claims that "the average American buyer wants a standard contract which, without reading, he can feel sure will protect his interests fairly."⁴⁰

Together with clear rate statement, truthful advertising and standard contract forms will facilitate more effective price competition throughout the instalment-sales credit field. It is price (the heart of the contract in legal terminology) which was emphasized in the theoretical sections above as the guide for wise decisions by producers and consumers alike. For consumers to attempt in practice the maximization of their satisfactions in the use of instalment credit, the price of such credit must be free from artificial restraint. The interest rate, like prices generally, cannot be spoken of in

³⁷ Philip Henry Wicksteed, *The Common Sense of Political Economy* (London: G. Routledge & Sons, 1933), chap. iii.

³⁸ It is a commonplace remark that a person's consumption is markedly influenced by the way of life of the group to which he belongs. If, as is often true, the possession of certain, say, durable, commodities is considered "essential" by the members of a group, he will be concerned not so much with the problem of whether or not to buy the durables as he will be with the problem of buying them in the most advantageous way. The use of instalment credit has come to be taken for granted (i.e., is part of the institutional pattern) as "the most advantageous way" by many consumers. Critics who denounce as irrational consumers' "alleged plunge into instalment debt" underestimate, in the writer's opinion, the influence of institutional patterns on behavior. To the extent that the writer's position is correct, these critics, partially at least, misconstrue the meaning of rational behavior under actual conditions.

³⁹ "Rate Regulation in the Field of Consumer Credit," *Journal of Business of the University of Chicago*, Vol. XVI (January and April, 1943).

⁴⁰ Haring, *op. cit.*, p. 280.

the abstract but only in connection with a definite quantity. Quantity in this field refers to the amount of credit in dollars and the length of time for which it is granted. In the case of instalment-sales credit the amount in dollars is determined in the first instance by the size of the down payment. Therefore, for price competition to be effective, sellers must be free to vary not only the rate but the credit terms as conditions seem to warrant. Given effective price competition, consumers on the whole are probably sufficiently calculating to use instalment-sales credit as a means of increasing their satisfactions through time.

The general point of view taken here is that positive social action is necessary to maintain a competitive system. The program of the Federal Trade Commission in trying to set up "rules of the game" represents a welcome start along the right path. The whole of the preceding discussion has omitted consideration of bank credit, that is, has assumed that credit is limited to savings. Given this assumption, sellers cannot, by varying their credit terms, exercise any appreciable influence on the total credit outstanding. There would be no need to regulate credit terms (down payment and payment period), since, as part of the heart of the contract, they would be governed by competition. Once the banking mechanism as we know it is introduced, the volume of credit is no longer limited in short periods of time to savings, and it becomes highly volatile. Professor Pigou's well-known dictum has emphasized the importance of reasonable cyclical stability to consumer welfare. Control which otherwise might not be defensible may become necessary to this end. One of the major weapons lies in giving the monetary authorities some control over the volume of credit. Instalment-sales

credit is only a small part of total credit and might not seem to warrant separate attention. Yet it is possible, as a few writers have suggested, to make a limited case for its direct control.⁴¹

Qualitative maximization of satisfaction under actual conditions.—There remain for discussion problems concerning the relation between anticipated credit and what has been termed the qualitative satisfaction resulting from its use. In the main these problems concern actual conditions, and so, for reasons already given, the discussion is restricted to instalment credit. Many writers have touched on one or more of these problems but, unfortunately, in a superficial manner. First, and much mistreated, is the question of the effect of instalment credit on the allocation of consumer spending between luxuries and necessities. Two early citations indicate the issue. On the one hand, instalment credit is denounced because it diverts purchasing power in the direction of luxuries at the "expense of more solid and useful staples, as well as the cultural and welfare type of goods,"⁴² and, on the other hand, it is extolled because it facilitates the purchase of luxuries.⁴³

It remained for Seligman to analyze the problem in greater detail and set the fashion for most writers who come after him. In a brilliant burst of dialectics and relying on such eminent authorities as Hume and Voltaire, he argues against the legitimacy of drawing a sharp distinction between the terms "necessaries" and "luxuries." His starting-point contrasts the present-day concept of luxury with those of older times, the major difference

⁴¹ See chap. v.

⁴² J. G. Frederick, "Economics of Instalment Selling," *Barron's*, VI (April, 1926), 8.

⁴³ W. H. Wood, "Instalment Selling O.K.," *Bankers Monthly*, XLIV (January, 1927), 29.

being that the modern one is ethically neutral.⁴⁴ He adds in explanation that "the modern point of view is to emphasize the relative character of all expenditure, to distinguish between beneficial and harmful consumption from the social point of view, and to stress the importance of the standard of life in making for economic and moral progress."⁴⁵ The quotation is in sharp contradiction to his assertion that the problem is nonethical. However, Seligman is following the fashion now so prevalent of trying to divorce economics and ethics. Only in analyses taking as given the conditions of rationality, etc., are no ethical problems involved. But it should be added that the choice of the assumptions in the first place is definitely an ethical one.

To elaborate his position, Seligman makes three points. First, it is impossible to characterize any particular commodity as a luxury once for all. Whether it is or not depends on the circumstances, including therein the standard of living of the user. Second, being costly does not per se make a commodity an undesirable form of consumption. Third, there is a presumption against interfering with individual freedom of choice in consumption, and the law should intervene only to preserve such freedom.⁴⁶ He concludes:

A luxury may be no less economically justifiable than a necessary; a comfort may be no less morally reprehensible than a luxury. We are led therefore to declare as essentially invalid the widespread objection to instalment selling on the ground that it favors a regrettable tendency to purchase luxuries at the cost of more important comforts and necessities.⁴⁷

Subsequent writers in increasing numbers have shifted over to his position that

the problem is of the straw-man variety; relatively few can be found who take the two extreme points of view noted at the outset.

The key to Seligman's whole analysis lies in the justifiable point that whether or not a commodity is a luxury depends on the standard of living of the user. An approximate designation of a commodity as a luxury can best be made at the subsistence level, and even here one must proceed cautiously. A further difficulty lies in the fact that persons below a subsistence level may find more satisfaction in forgoing a necessary, such as food, in favor of a commodity less essential to physical existence. The presence of the family complicates the problem because of the impossibility of comparing, let alone adding up, the satisfactions accruing to its members from alternative courses of action. Available data indicate that some families with incomes below \$1,000, and even below \$500, a year buy commodities on the instalment plan.⁴⁸ In some cases the commodity so bought is the automobile, probably at the expense of commodities more necessary to physical existence. In this event instalment credit leads to luxury buying in the invidious sense of the word.

However (what may sound like casuistry should, upon consideration, appear otherwise), this is not to say that instalment-sales credit is the cause of unwise purchases.⁴⁹ As already noted, the irrationality of some consumers cannot necessarily be charged to instalment credit. True, many high-priced, durable purchases could have been made less readily in the absence of such credit for the simple reason that, without the legal safeguards surrounding it, sellers would not

⁴⁴ Seligman, *op. cit.*, I, 215-16.

⁴⁵ *Ibid.*, p. 218.

⁴⁶ *Ibid.*, pp. 222-25.

⁴⁷ *Ibid.*, p. 225.

⁴⁸ Weiss, *op. cit.*, p. 100, and Plummer and Young, *op. cit.*, p. 78.

⁴⁹ See Weiss for an overly critical attitude.

have assumed the credit risks involved. But there is no assurance that the spending members of the family would have diverted the money so released to necessities. The well-established observational fact of the excessive use of alcohol among many of the lower-income groups is appropriate in this connection. Seligman has probably gone too far in absolving instalment credit of all blame. Nevertheless, the presence of some undesirable elements in a given sphere does not necessarily call for its elimination or even drastic curtailment. It is essential to weigh alternatives. The writer feels that a strong presumption in favor of freedom of consumer choice exists. Legislation requiring clear rate statement, standard contract forms, and truthful advertising is likely to produce fewer evil effects than would a more drastic legislative program.⁵⁰ To deny this is to deny the workability of a free-enterprise (or, for that matter, a free socialist) system. Economists are often accused of oversimplifying complex social problems, and the present conclusions may be so construed by some. The writer readily admits the tremendous social problems inherent in the unwise behavior of many members of the lower-income group. But he is not convinced that directing them in their every move is a lesser evil than giving them some freedom even though they make some mistakes.

Scattered throughout the literature are references to the superiority of durable over ephemeral goods. Since instalment-sales credit historically has been connected with durables, the implication is that such credit facilitates a refinement of consumption. For example, one study,

after mentioning some of the results accruing from the use of instalment-sales credit, among which is the substitution of durable for ephemeral goods, says: "These are all things which raise his [buyer's] self-respect . . . and bring him a lasting return in better living as contrasted with pleasures which are forgotten tomorrow."⁵¹ On first reading it might appear that this citation is nothing more than a restatement of the luxury-necessary problem. Such is not the case. To illustrate, by this view if a consumer has the choice between two luxuries, one durable, the other ephemeral, the former should be chosen, since it leads to more lasting, and hence higher quality, satisfaction. The analogous example of a choice between two necessities presents more complications. The writer finds it difficult to attach much importance to a discussion of the choice between necessities, particularly among individuals or families near or below a subsistence level.

Danielian puts the issue another way. His analysis, to recall, is somewhat critical of instalment-sales credit on the grounds that it diminishes the user's satisfaction in a quantitative sense. He amends this to the extent that the user experiences a change in taste favorable to the enjoyment of durable goods and adds that one might be disposed to argue that the latter have a technical superiority over ephemeral utilities.⁵² He hastens to say that their purchase on credit eliminates the conditions which account for this superiority. This reservation is not in point here if the conclusions of the preceding part of this chapter be substituted for his.

⁵⁰ Transcending direct legislative action, there is much to be done in furthering the intelligent use of consumer credit. Education of consumers in buying and in the use of credit, and provision of legal advice at nominal cost are several examples.

⁵¹ American Federation of Labor, "Research Report on Instalment Buying," *American Federationist*, XXXIV (April, 1927), 480.

⁵² *Op. cit.*, p. 399.

The writer is willing to admit a certain validity in the argument. There is undoubtedly a pride of ownership as such which in the nature of the case can attach only to durable commodities. An analogy from another field is the statement of Huxley's Mr. Cardan to the effect that one feels a superior satisfaction in being able to describe an art object in several languages even though it adds nothing to one's knowledge or appreciation of the object. That instalment-sales credit is of much importance in making possible this higher quality satisfaction is doubtful.

The third and fourth qualitative links between instalment-sales credit and satisfaction hinge around leisure. Those writers touching on the subject have been very general in their statements and, therefore, for the most part, do not provide the basis for an adequate discussion.⁵³ It may be asked, Does the use of instalment-sales credit influence the way in which the user spends his leisure and, if so, with what result on his satisfaction? It seems beyond dispute that the answer to the first part of the question is in the affirmative. Historically, the greater part of instalment-sales credit has been extended to permit the purchase of what may be termed "recreation commodities"—for example, automobiles, radios, musical instruments, and camera equipment. This does not mean that these commodities would not have been purchased in the absence of credit. It merely means that, given the presence of such credit, many consumers have decided that they can increase their satisfaction through time by borrowing. It is a matter of common observation that these commodities have, in the past several

decades, revolutionized the manner in which many persons have spent their leisure. Since leisure is a form of consumption, the conclusions reached in the previous pages on the effect of anticipated credit on consumer satisfaction are applicable here.

The last problem concerns the relation of instalment-sales credit to the margin between leisure and nonleisure time. If all productive effort were directly tied up to the exchange (pecuniary) mechanism, the problem would resolve itself into the influence of such credit on the amount of time spent on earning objective (money) income and leisure, respectively. However, a not inconsequential amount of productive effort receives no direct money income, that is, it is not directly affiliated with the pecuniary system. Of peculiar significance here is the work done for the family by the housewife. The second most important category of commodities purchased with instalment-sales credit are those which reduce work in the home (e.g., washing and sewing machines, vacuum cleaners, refrigerators, and automatic heating devices). In so far as instalment-sales credit is used for the purchase of these commodities, it is instrumental in aiding the housewife to perform her duties in a shorter time.⁵⁴ One study claims that through the availability of washing machines on the instalment plan the health of many housewives has been improved.⁵⁵

The essential question to answer is whether housewives use any time so released to add to their leisure or, as Professor Plummer seems to take for grant-

⁵³ See, e.g., Warren Pulver, "Is Instalment Selling a Blessing or a Menace?" *Advertising and Selling Fortnightly*, VIII (November 3, 1926), 30.

⁵⁴ Wilbur C. Plummer, "Social and Economic Consequences of Buying on the Instalment Plan," *Annals of the American Academy of Political and Social Science*, CXXIX (January, 1927), 14.

⁵⁵ Charles O. Hardy (ed.), *Consumer Credit and Its Uses* (New York: Prentice-Hall, Inc., 1938), p. 137.

ed,⁵⁶ to augment the family's money income. Even assuming willingness, it is doubtful that sufficient leisure results to enable housewives to take outside money-making jobs. This conclusion is based on general observation; statistical data could not be refined sufficiently to be of service. Housewives could augment the family money income in another way, namely, by using the added time to make commercial products in the home. This sort of production is of negligible importance in the United States today. Further, it is doubtful if many housewives would be interested, since psychologically such work is considered menial, a mark of tenement status. The same work done for charity has an altogether different connotation. It may be concluded that within the family unit instalment-sales credit may exercise influence on the amount of leisure time of the housewife, the member who is not directly tied up to the pecuniary system.

Credit extended on home-work-reduction commodities is consumer credit rather than producer credit. Psychic income or satisfaction depends for its ultimate existence on money income or income in the objective sense of a command over commodities. It would be impossible for an individual as such to enjoy a psychic income unless he had a money income. When the family is introduced, it becomes necessary, from the point of view of earning money income, to think of the members not as individuals but as a unit. Only credit which permits an augmenting of the money income of the group is strictly producer credit. Credit which augments the psychic income of one or more members but has no effect on the group's money income is consumer credit. That such credit may affect psychic income has been argued through-

out this part of the chapter. That such credit may affect money income by bringing more persons into the exchange mechanism seems unlikely. Section B below extends this conclusion to the relation in general of consumer credit to money income. The failure of writers to distinguish carefully the pecuniary and nonpecuniary uses of resources has, partially at least, caused many of them to deny the essential validity of the distinction between producer and consumer credit.

UNANTICIPATED CREDIT AND THE MAXIMIZATION OF SATISFACTION

To this point the discussion has been limited to anticipated consumer credit. According to data recently made available, anticipated credit accounted on the average for about 85 per cent of the total consumer credit outstanding at the close of each year over the period 1923-37.⁵⁷ The remainder is unanticipated or deficit credit (it is represented by that part of cash-loan credit not classifiable as instalment-sales credit) and arises because of emergencies which the individual or family is unprepared to meet without outside financial aid. These emergencies are of two sorts: loss of income and unforeseen expenditures. In the case of loss of income probably, and in the event of unforeseen expenditures surely, the consumer's spending pattern will be different from what it would otherwise have been. Presumably, too, the satisfaction realized will be less from the emergency expenditure than from that originally planned. But a comparison of this kind lacks meaning, since the individual has no real freedom of choice in the matter.

A comparison between the satisfac-

⁵⁶ *Op. cit.*, p. 14.

⁵⁷ Rolf Nugent, *Consumer Credit and Economic Stability* (New York: Russell Sage Foundation, 1939), p. 124.

tion which would be realized if the credit were or were not available, although patently more equitable, does not lend itself to analysis of a meaningful sort. Deficit credit is defensible on entirely different grounds. As many writers have emphasized, it is in the interest of social stability that the financial independence of families be maintained.⁵⁸ Deficit credit is one of the means to this end for those families who will be able to repay the debt without degenerating to the status of relief. By lowering the price of deficit credit, the reforms of the past several decades have brought such credit within the reach of more people. In the same period, for reasons developed elsewhere,⁵⁹ the need for deficit credit has, relatively speaking, been declining. Both of these trends have been desirable.

B. THE RELATION OF CONSUMER CREDIT TO THE MAXIMIZATION OF MONEY INCOME

An individual may realize a money income from property owned and/or from his labor. It is possible conceptually to divide the income from labor into (1) that part which is due to the general state of the economy of which the laborer is a part (i.e., technical efficiency, the size of production units, the extent of the market and credit organization, the degree of business stability, and, more ultimately, the relative and absolute supply of the several factors of production) and (2) that part which is due to the laborer's own personal efforts. Only the relation of anticipated credit to these personal efforts is at issue here, since this

chapter is limited to a discussion of the direct effect of credit on consumer behavior. The relation of anticipated credit to the general state of the economy is covered in the two subsequent chapters. Specifically, the question becomes: What effect, if any, does the use of anticipated consumer credit have on the user's own productive effort in making a money income? For the present the analysis is carried on at a theoretical level, and hence the conclusions apply equally to lump-sum and instalment credit. Most of the writers to be cited restrict their analyses to instalment credit; to avoid misunderstanding, each writer's usage is adhered to in discussing his views.

The writer wishes to state at the outset that the issue should never have been seriously considered, and might not have been, had Seligman not emphasized it. Before his emphasis, except for the somewhat crude and unsupported statements of some enthusiasts, writers in the main adopted the only defensible position possible, namely, that anticipated credit is not a means whereby its user can increase his money income through added personal productive effort.

Seligman treats the problem in the section of his book devoted to discussion of the effect of consumer credit on savings. He notes briefly that savings are affected by changes in the percentage of income an individual reserves for future use and then remarks: "Of greater significance, however, is the effect of instalment buying upon the magnitude of the incomes. In other words the question is: Does instalment selling encourage or discourage effort?"⁶⁰

He says that where instalment-sales credit is "used for productive purposes in the sense of increasing the money income of the individual there can be no

⁵⁸ See the seven articles grouped under the title, "The Sociological Foundations in the Economic Order," *Annals of the American Academy of Political and Social Science*, CXCVI (March, 1938), 1-51.

⁵⁹ Wallace P. Mors, "Theories of Consumer Credit" (unpublished Ph.D. dissertation, School of Business, University of Chicago, 1942), chap. ii.

⁶⁰ *Op. cit.*, I, 274.

question as to the consequence."⁶¹ He is not content to stop there, as the following somewhat long quotation indicates.

But what is true of money incomes is true also of other incomes. If we revert to our preceding analysis we remember that consumption is in a wider sense not the opposite of production. We have seen that there may be a productive utilization of wealth as well as a neutral or wasteful or destructive utilization. If the augmented satisfaction of a purely psychical nature, conferred upon an individual by the acquisition of a commodity, would otherwise not have existed is it not entirely possible—nay even likely—that these augmented satisfactions will be brought into such relations with his productive capacity as to increase his efficiency, and will not the psychic income in this way be after all transmuted into money income? In other words, will not the possession of the durable commodity actually increase the ability of the individual to make renewed and augmented exertions?⁶²

According to Seligman's analysis, increased money income can come about only if instalment-sales credit has previously brought increased psychic income to its users. That increased psychic income will tend to result has already been established in Section A above and may be accepted here as valid without further comment. He does not hold, however, that increased psychic income will always lead, through added productive effort, to greater money income. Rather he says very tentatively, should it be said rhetorically with Danielian, that such a result may take place.

It would seem incumbent upon those of Seligman's belief to show under what conditions the last step in the chain of events set up will occur.⁶³ Danielian has remarked:

The causal relationship involved is undetermined and not subject to conclusive treat-

ment. It is hard to prove that there is any causal relation between the enjoyment of a semi-luxury or a luxury (using these words without ethical connotations) and the productive efficiency of the man who is able to afford it.⁶⁴

It seems desirable to go beyond shifting the burden of proof, if possible, and produce arguments revealing the untenability of Seligman's position. The temerity of one writer may be noted somewhat indulgently. After making the unsupported statement that instalment-sales credit provides an incentive to greater productivity, he boldly proclaims that "it would seem to be the dissenter's place to prove its irrelevance."⁶⁵

At any rate, one such attempt, only partially successful, has been made. An additional point of Seligman's must be reproduced in order to place this criticism of his position in its proper perspective. This is the argument, more fully discussed in Section C of this chapter, that instalment-sales credit compels people to be thrifty by making them save to meet the payments as they come due. Frank Morris protests that "if a man is compelled under the system to save in order to pay the instalments, clearly there must be a time when his consumption of other commodities must be reduced, thus discounting the claim of general increased productivity."⁶⁶ His point is not conclusive. It is true that the borrower must reduce his spending in future income periods to meet the payments on his instalment debt, but this will curtail consumption in a relative, not an absolute, sense in those periods if it be assumed or proved that the borrower's

⁶⁴ *Op. cit.*, pp. 399-401.

⁶⁵ H. Bertram Lewis, "Instalment Facts Refute Instalment Fancies," *Bankers Magazine*, CXIII (August, 1926), 169.

⁶⁶ "Instalment Buying: Social and Economic Aspects," *Bankers, Insurance Managers and Agents Magazine*, CXXV (May, 1928), 710.

⁶¹ *Ibid.*, p. 276.

⁶² *Ibid.*, p. 277.

⁶³ If space permitted, many could be cited who echo his position. None of them adds anything new.

money income, owing to the presence of the debt, is increasing. Whether or not the money income will be increasing is, of course, the crux of the matter.

Morris goes on to say that Seligman's method of meeting this dilemma, that of introducing psychic income,

is ingenious, if not convincing . . . it adds new terrors for the average student of economics, and in the writer's view reduces all monetary problems to chaos. The theory of a "psychic" income would be equally invoked to justify the squandermania of a government or the bankruptcy of a spendthrift, but could hardly figure as realizable assets on the liquidation of the estate.⁶⁷

The meaning of this sweeping quotation is not clear. His awareness of the unsatisfactory nature of his criticism seems to be indicated by his somewhat lame conclusion:

But even if we admit the possibility of a "psychic" income increasing the productivity of the instalment buyer, there is no evidence that this increased productivity in any way equals the increased purchasing power with which he is equipped.⁶⁸

A more extended refutation of Seligman's position is attempted below. Whether the writers quoted were aware of it or not, the real issue is that of work psychology or motivation, namely, whether instalment-sales credit (more generally anticipated credit) provides an incentive, over and above what other incentives may already exist, for the borrower to work harder, produce more, and so augment his money income. For emphasis, the position taken in chapter i that commodities bought with consumer credit do not of themselves provide the means of increasing the user's money income may be repeated. Such credit is producer credit. Seligman specifically denies the validity of the producer-consumer credit dichotomy, but that has no

relevance here, since he is very specific in his statement that instalment-sales credit may increase the money income of borrowers through added productive effort on their part, over and above, by implication, any money income realized from the commodities themselves.

An analysis of the problem under theoretical conditions (i.e., given knowledge, rationality, a free market, and neutral money) again provides the proper starting-point. Contrary to Morris, the concept of psychic income must be included in the discussion and need not, if rightly handled, add "new terrors." Individuals, under the assumed theoretical conditions, attempt, on the one hand, to maximize their psychic income in the allocation of money income among commodities and, on the other, to maximize the money income in the allocation of the factors of production within their control among occupations.⁶⁹ Although the maximization of psychic income is logically anterior to the maximization of money income, the two are simultaneously carried on in the market and together determine price. Included in the maximization of psychic income are the decisions of individuals on the timing of their spending of money income. Persons giving relative preference to the present will be borrowers; those more concerned with the future will be lenders.

For society as a whole any anticipated consumer credit which exists has already been taken into account by consumers in the maximization of their psychic income. The presence of such credit can augment the money income of society only by increasing the productivity of the factors of production. Increased pro-

⁶⁹ For a detailed explanation of how these two types of allocation are effected refer to any first-rate text on economics. For a thorough treatment at a high level of abstraction see Knight, "Notes on Utility and Cost," *op. cit.*

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

ductivity can come about either through better organization or through greater personal productive effort on the part of individuals. (A third possibility, the more intensive use of capital, has not been touched upon in the consumer-credit literature, and it seems well to "let sleeping dogs lie.") Greater personal effort is ruled out by hypothesis, since, being calculating, individuals exert their maximum productive efforts whether they avail themselves of credit or not. The presence of credit provides no added work incentive.

The conclusion just reached applies also to each individual. Although inter-related for society as a whole, maximization of psychic income and maximization of money income are separate management problems to him. This follows from the fact that the individual uses his factors to produce a negligible proportion of the commodities he consumes and from the further fact that for him factor and commodity prices are parameters. Included in these parameters is the price of credit. To say that the use of credit gives the individual an added incentive to reallocate his factors is to say that he did not allocate them for maximum productivity in the first place. Such a conclusion is not sound, given the assumption of rationality. Thus, while credit may add to the user's psychic income, it cannot translate itself, through greater productive efforts on the part of those using it, into added money income. At least this is true under theoretical conditions.

The very tentative position of Seligman and his followers, if valid to any extent, must be so under conditions in which individuals are not entirely rational. This introduces consideration of actual conditions, and, in line with the methodology previously adopted, the dis-

cussion from this point on is limited to (anticipated) instalment credit. Seligman is estopped from claiming irrationality because, just previous to making his cautious statement concerning the effect of instalment-sales credit on productive effort, he had argued at some length to show that instalment buyers on the whole buy rationally.⁷⁰ If they behave rationally in buying, there is no reason to expect them to behave otherwise in their efforts to maximize money incomes. Professor Huegy, one of Seligman's followers, is even more self-contradictory, if possible, since he argues that the increased productive effort will result from the use of instalment-sales credit only in those cases in which consumer borrowers have correctly (i.e., rationally) estimated the satisfactions to be obtained from the commodities bought with credit.

Although economic analysis cannot be as precise in its conclusions under actual as under theoretical conditions, a healthy skepticism that Seligman's position is valid even to a negligible extent seems justifiable. Reduced to extreme form, it involves an infinite spiral in which greater psychic income leads to greater money income, which in turn leads to greater psychic income, etc. This whole process would be started by the presence of instalment credit. Stated in this form, its absurdity becomes more apparent.

One writer shrewdly points out that it is easy to reverse the argument and claim that instalment-sales credit, by making commodities easy to get, decreases the urge to work.⁷¹ The negatively sloping supply curve characteristic of labor in the long run may somewhat facetiously be introduced in this connection. Seriously speaking, observation would indicate that most people are in-

⁷⁰ *Op. cit.*, I, 103.

⁷¹ Morris, *op. cit.*, p. 710.

interested in making as great a money income as possible without regard to the presence of instalment-sales credit. Less satisfactory than a direct refutation and presented here merely as a supplement to it is the argument that, even granting provisionally that some persons behave as Seligman hesitatingly suggests, there is some doubt of their being able to make effective use of the added incentive. Conditions external to workers are very important in our present industrial setup. For example, hours are fixed by custom, and the speed of working is often governed by machinery. Furthermore, many workers resent any unusual productive efforts on the part of others, a tendency which is being institutionalized by trade-unions.

Paradoxically, unanticipated credit may have some effect, a negative one, on the user's money income. In so far as it tides him over a bad period and helps keep his morale intact, it may aid in keeping his productive efforts up to par. The importance of the point cannot be dogmatically asserted, but it is probably not very great.⁷²

C. THE RELATION OF CONSUMER CREDIT TO THRIFT

Two meanings of thrift may be distinguished. The earlier or Puritanical one counsels the individual to live well within his income "so that there would always be a fund available against the unforeseen needs of tomorrow."⁷³ An obvious corollary is the avoidance of debt. Following this precept permits savings which through lending to producer borrowers provides the basis for income accumulation in the future. Discussion of the relation of anticipated credit to this

form of thrift is postponed until its relation to thrift in the newer meaning has been considered. In both cases actual conditions are assumed; hence the analysis is limited to (anticipated) instalment credit.

The newer meaning of the term "thrift."

—The keynote of the newer definition of thrift is contained in the following quotation: "True thrift is concerned chiefly with relatively small expenditures. Speaking generally, it is thriftless to go into debt for food and clothing."⁷⁴ This statement is amplified by the claim that persons with savings accounts, accumulated for emergencies or investment, would be foolish to use these savings for such things as "an automobile, a piano, a talking machine or anything else they did not actually need. On the other hand it would not be foolish for them to purchase these things out of current earnings if they could still add a little to their savings."⁷⁵ To another source, "this [using credit to buy durable commodities] is a different form of thrift from that displayed in the accumulation of savings deposits but it is thrift."⁷⁶

The commodities referred to in the above citations to illustrate the new conception of thrift are of the durable, high-priced type which cannot, for many individuals, be bought out of a given income-period income. Consumers wishing these commodities have the two alternatives of saving and buying later or buying sooner on credit. This is nothing more than one aspect of the problem of maximizing psychic income through the appropriate balancing of present and future satisfactions. Stated differently, the rela-

⁷⁴ "Time Sales of Automobiles Have Reached Enormous Proportions," *Automotive Industries*, XLIX (July 26, 1923), 161.

⁷⁵ *Ibid.*

⁷⁶ Hardy (ed.), *op. cit.*, p. 147.

⁷² An analysis of case studies might shed added light on this problem.

⁷³ Hardy (ed.), *op. cit.*, p. 128.

tion of consumer credit to thrift, in the newer meaning of the term, represents in another form the relation of consumer credit to the maximization of psychic income which has already been fully discussed in Section A.

The older or Puritanical meaning of the term "thrift."—The writer has argued elsewhere that, historically speaking, the breakdown of thrift patterns is one of the factors responsible for the growth of instalment credit rather than the converse being the case.⁷⁷ Here certain nonhistorical points may be explored briefly. Since thrift in its traditional sense means the avoidance of debt and instalment credit is per se debt, it seems difficult to see how instalment credit could encourage thrift.

Three lines of argument, all extremely dubious, have been advanced. Seligman is largely responsible for the first. He makes a halfhearted attempt at a direct discussion of the problem by this rhetorical question: "As regards the desire to save, does not the mere possession of something which has long been wanted but which it has been impossible hitherto to acquire, often transmute the attitude of the individual?" After seven consecutive, similar rhetorical questions he concludes: "To the extent that the instalment purchase of a durable commodity which is worth having stimulates the possessor to renewed and increased exertion, it acts as an encouragement, and not as a discouragement, to savings."⁷⁸

The unsatisfactory nature of such an argument is indicated not only by the extreme caution of his conclusion⁷⁹ but by his next statement that "there is,

however, another and still more important side to this subject. We come in other words to deal not so much with the desire to save as with the capacity to save." Here Seligman repeats the tentative argument, already discussed in Section B above, that instalment-sales credit may result in a larger money income on the part of those using it. This larger money income in turn makes for a greater capacity to save which, in turn, together with the direct effect already noted, augments the desire to save. The whole argument fails if instalment-sales credit leads to no added money income. That it does not has already been shown. Seligman's followers add little to his analytical apparatus and need not be covered in detail.⁸⁰

A second argument is negative in nature. Plummer, one of its early exponents, points to the tremendous growth of savings which has taken place since World War I, the period of the most rapid growth in instalment-sales credit. From this he reaches the tentative conclusion that, at least, instalment-sales credit has failed to dissipate or dry up savings. It is presumed that he means the absolute volume of savings rather than the volume of savings relative to the size of the national income. He concludes that instalment-sales credit has not discouraged thrift.⁸¹ Seligman makes the obvious observation that this whole type of argument is of slight importance unless it can be shown that a causal relation exists between instalment-sales credit and savings. Until this is done, all that can be said is that instalment-sales credit has not prevented an absolute growth of savings.

⁷⁷ "Theories of Consumer Credit," chap. ii.

⁷⁸ *Op. cit.*, I, 275-76.

⁷⁹ He is somewhat better than popular writers in that he refuses to give more than a tentative conclusion when his reasoning is nebulous. How much better is another question.

⁸⁰ For a somewhat incautious adoption of Seligman's position see Parker, *op. cit.*, July, 1931, p. 5, and August, 1931, p. 7.

⁸¹ Plummer, *op. cit.*, pp. 31-40.

A further point which has escaped notice is of some importance. It is necessary that savings increase at least *pari passu* with consumer credit in general. The latter represents borrowing and is possible only to the extent that funds are available for such a purpose. These funds in a system abstracting from bank credit must come out of the savings of nonborrowers. If producer credit is assumed absent and no uncertainty exists, savings and consumer credit for society would always be equal in amount. If producer credit is reintroduced, the total producer and consumer credit (after allowing for self-investment by savers) will equal savings. In order for consumer credit to exist, there must be thrift on the part of some individuals in the economy. But they are the individuals who do the lending, not the borrowing. Hence it is difficult to see how the use of consumer credit can be identified directly with thriftiness, in the Puritanical sense of the term.

The third argument tacitly admits that instalment credit is not of itself a form of thrift but claims that the use of instalment credit may or will, depending on the writer, exert, as a secondary effect, a pull in that direction. Huegy provides perhaps the best example. He says that borrowers are more or less compelled to budget in order to meet their payments as they come due and adds that "this will promote saving by forcing habits of thrift."⁸² Even so eminent an authority as Fisher mentions this point.⁸³ Seligman subsumes the same idea under the broader one that the periodic payments permit borrowers "to create more intelligent judgments in reference to the spending program as a whole."⁸⁴

A priori reasoning can only reach the conclusion that the above contention

may be true in some cases. How many cannot be stated. A statistical inquiry of the savings habits of persons before and after or during the use of instalment-sales credit would be of some value in assessing its relative importance. Since the writer knows of no such study, the conclusion must be left standing for what it is worth. Three consumer-credit agencies—industrial banks, commercial banks, and credit unions—have definite thrift programs apart from their lending activities. These programs are not in point here.

In conclusion, thrift, in the Puritanical sense of the term, at least to the extent of providing for emergencies, is unquestionably desirable. Thrift in this sense is not incompatible with the use of anticipated credit to buy commodities which are high in price relative to the income a person receives each income period. The sweeping generalization that all consumer borrowers are unthriftly cannot be maintained. Neither, however, is it valid to argue that the use of consumer credit, of itself, promotes thrift on the part of those using it.

SUMMARY

Under theoretical conditions anticipated consumer credit adds to the psychic income of its users by permitting them the optimum arrangement of their expenditures in time. Such credit does not provide an incentive, over and above the natural inclination to maximization, for borrowers to increase their personal productive efforts and hence their money incomes, nor does it encourage thrift (money saving).

The conclusions under actual conditions are in each instance about the same, although in the nature of the case economic analysis can no longer be quite so definitive. In spite of the presence of

⁸² *Op. cit.*, p. 103.

⁸³ *Op. cit.*, p. 84.

⁸⁴ *Op. cit.*, I, 267.

abuses, the presumption is strong that, given sufficient information on price and other provisions of the contract, consumers will, in most instances, use credit facilities in a manner beneficial to them. For historical reasons the discussion of actual conditions has been limited to instalment (beyond-the-income-period) credit.

Unanticipated credit is defensible on entirely different grounds, namely, those of keeping the family or individual on a normally functioning basis during emergencies. This applies only to those who will not become relief cases because of the burden of debt. Like anticipated credit, unanticipated credit does not enhance the money income of borrowers or stimulate habits of thrift (money saving) in any perceptible degree.

The analysis has indicated that under theoretical conditions no economic distinction need be made between income-period and beyond-the-income-period credit. The uncertainty of the real world through its effects on risks of lending makes the distinction of greater impor-

tance in discussing actual conditions. The failure to be clear on the assumptions underlying their analyses has led many writers into making unwarranted statements.

The applicability of the conclusions of this study to mortgage credit may now be made more precise. The theoretical sections of this chapter and of the following two may be extended to mortgage credit without reservation. The in-addition-to problems attaching to instalment credit and discussed in the sections dealing with actual conditions have, however, no precise analogy in the field of mortgage credit. Until the New Deal period the instalment method was little used in home financing; further, the social stigma attached to instalment selling has been absent there. In general, only the conclusions of the more theoretical parts of this study may be carried over intact into the mortgage-credit field. The remaining ones require modification to meet the much different historical background which has characterized the development of home financing.

CHAPTER III

CONSUMER CREDIT AND THE REAL NATIONAL INCOME UNDER FULL-EMPLOYMENT CONDITIONS

WE TURN now to the question of the effect of consumer credit on the real national income¹ under conditions of full employment of the factors of production. A word of defense may be offered for this chapter in view of the fact that classical analysis of this

problem, though cursory, seems irrefutable and in view of the present-day tendency to concentrate attention on under-employment conditions. With regard to conditions of full employment, because certain consumer-credit writers have questioned classical conclusions, it becomes necessary to re-examine the whole question. Subsequent analysis will not only bring out the nature of the conflict

¹ A. C. Pigou's usage is followed here (see his *Economics of Welfare* [London: Macmillan & Co., Ltd., 1924], chap. iii).

but also show that the classicists hold the more defensible position.

As to unemployment conditions, one can only say that to admit their importance is not to deny the usefulness of analysis of more simple conditions.² The analysis of simplified conditions not only affords mental exercise but focuses attention on certain essential relationships which tend to be blurred over by the greater number of variables which must be taken into account in underemployment analysis. Because some of the resulting conclusions are at variance with those of underemployment analysis, the reasons for such divergence are thrown into clearer relief.

It is assumed that the factors of production tend to be distributed so as to maximize their money returns and that firms have freedom of entry into the market. The last assumption does not necessarily mean that competition is perfect; in fact, distinctions between perfect and imperfect conditions will be introduced at the appropriate point. Uncertainty is again assumed away. A somewhat less rigid procedure would be to admit it but to assume a sufficiently flexible system to allow for relatively smooth corrections of errors in anticipation. For the time being all credit is assumed to be transfer credit; the effects of introducing expansion credit will be considered briefly later on.

In any given time period the real na-

tional income is dependent ultimately upon the man-hours spent at work (this is a function of the number of workers and the number of hours each works as part of the exchange mechanism), the intensity with which workers work, the state of technology, the supply of capital, and the effectiveness of the allocation of resources among alternative uses. The last involves the behavior of demand, both in an aggregate and in a relative sense. Because consumer credit can influence the size of the real national income only through one or more of these factors, the procedure will be followed of first analyzing its relation to each one in turn and then drawing general conclusions therefrom. It should be emphasized that the discussion is restricted to the effect of consumer credit on the size (quantitatively) of the real national income and not on the respective welfares resulting from different sizes and distributions of the real national income.

WORK AND TECHNOLOGY

Ultimately, the man-hours worked are limited by the size of the population; there is no reason to believe that the size of the population is affected to any perceptible degree by the presence or absence of consumer credit. The effect of consumer credit on the number who actually work within the exchange mechanism and on the hours they work per day or week was discussed in the previous chapter and was found to be negligible.

There is no obvious connection between consumer credit and the state of technology, and no discussion of such a relation has been encountered in the literature. Further discussion, therefore, seems unwarranted. It should be stated that the phrase "state of technology" is limited here to inventions and to the efficiency with which given proportions

² In reading two works by Nugent which, it is true, deal only with conditions of underemployment, the writer gets the impression, perhaps mistakenly, that he is skeptical of the usefulness of stationary equilibrium analysis in matters concerning consumer credit (see Rolf Nugent, "Consumer Debt and the Business Cycle," in *Financing the Consumer*, ed. John H. Cover ["Journal of Business Studies in Business Administration," Vol. VII, No. 4 (Chicago: University of Chicago Press, 1937)], p. 3, and *Consumer Credit and Economic Stability* [New York: Russell Sage Foundation, 1939], p. 21).

of the factors of production are organized within a plant. The problem of "scale" is discussed later.

SAVINGS AND INVESTMENT

Consumer credit obviously has no influence on the amount of natural resources. The extent to which their exploitation is so affected may be subsumed under the discussion of the capital problem. Capital comes into existence as the result of saving and investment. Since these terms are far from standardized, it will be necessary to use them carefully in what follows. The psychic and money income concepts of the previous chapter are again utilized. It is assumed that all economic transactions take place through the exchange (money) mechanism. Except for farmers and housewives, the assumption is not too far dissimilar from conditions now existent in the United States. The growing practice of the reinvestment of earnings by corporations is in a sense a further exception.

The argument may be limited to durable consumer commodities, for it is entirely in connection with them that certain writers argue that consumer credit may be a form of savings. These writers restrict their discussion to instalment credit. The conclusions apply equally to lump-sum credit in so far as it is used for the purchase of durable goods. Because such use of lump-sum credit is not common, the problem under discussion represents one of the "in addition to" problems attaching to instalment credit.

Seligman, the earliest writer to treat the subject at length, notes that the buyer of durable consumer goods may use up the utilities therein after paying for them and concludes:

[Money] income employed to purchase at one time a good which is not used until a future date is really "saved" income. To the extent that in-

stalment selling offers at least the opportunity of so advancing utilization, it no doubt exerts some influence on savings in that particular sense.³

The first time the term "saved" is used, it is inclosed in quotation marks; the second time it is qualified by the phrase "in that particular sense." These usages raise several points. First of all, the quotation recognizes that durable commodities differ from nondurable goods in that the utilities in durable commodities are not entirely used up in the income period in which the durables were purchased (delivered). Alternatively stated, the acquisition of utilities exceeds their consumption as long as durable commodities are increasing in amount. This means that a tangible item is left intact at the end of the income period, one which provides the basis for further consumption in the future. As used here, the term "consumption," literally, "is the process by which goods are used up or their values destroyed."⁴ As already noted, consumption has two important alternative meanings: the enjoyment of the utilities inherent in commodities and the delivery of commodities into the hands of consumers. The first meaning seems redundant, since utilities will not be used up unless they are enjoyable; otherwise, the commodity will be destroyed or disposed of in some other manner. The second meaning is convenient for statistical purposes but analytically should be given another term. It is often pointed out that consumer credit is usually advanced to the full extent (or nearly so) of the price of the commodity being bought. Hence the credit exceeds the consumption in the

³ Edwin R. A. Seligman, *Economics of Instalment Selling* (New York: Harper & Bros., 1927), I, 273-74.

⁴ Nugent, *Consumer Credit and Economic Stability*, p. 31.

period of extension. The residue of the commodity not consumed at the end of the accounting period is capital, although, as elaborated below, this residue is not capital in the same sense as that resulting from productive investment.

Second, it is apparent from the quotation that Seligman regards this unused residue as that which is saved. Now it remains to inquire in what sense the unused part of the commodity is saving and, further, what the relation of consumer credit is to such saving. In the simplest case consumers who wish to buy durable consumer commodities may reduce their purchases of nondurables proportionally, maintain their purchases of nondurables, and use money savings previously built up to purchase durables, or they may follow some combination of the two. The first alternative reduces present relative to future consumption. The second reverses the procedure given the assumption that the money savings would some time have been consumed. This is not inconsistent with an uninterrupted increase of society's money savings through time. The method chosen depends on persons' tastes and judgments of the respective desirability of present and future utilities. Although in strict theory the problem is the same for all durables regardless of price, actually only those which are high in price would necessitate recourse on any scale to money savings. Whichever method is used, the buyers have at the end of the income period a portion of the durable commodity still unused.

It cannot be stressed too highly that this stored-up income is neither money income nor money saving. The commodity, being a form of consumer capital, is not available, or in many cases adaptable, for the purpose of augmenting the future money income of its owner or for

making purchasing power available to him at some future date. That being the case, the purchase of such commodities outright is not a form of money saving either at the time of purchase or later. A minor point may be made. In some cases commodities purchased are later sold secondhand by the original buyers. Such sales make money available for new uses. The proposition that consumers normally buy with such an intention in mind or the further one that they use this as a systematic means of accumulating money (purchasing power) in the future can hardly be upheld. The statement that "savings in money do not, of course, suffer the physical depreciation characteristic of such commodities as the automobile, which represent the 'savings' of those buying on the instalment plan, although the purchasing power of dollars may decline"⁵ is surely not convincing. The change in the value of the dollar is not a certainty, but depreciation is.

The purchase of durable commodities on credit may now be considered. In this case those consumers who have no money savings or who do not wish to use what money savings they have may buy high-priced, durable commodities without reducing their purchases of nondurables to the full extent of the price of the durables. Consumers need carry this reduction only to the extent of the money outlay necessary to obtain delivery of such durables, the balance being financed through borrowing. As in the case of consumers who buy durables outright, consumer borrowers now have at the end of the income period of purchase a tangible commodity capable of yielding utility or psychic income in the future. In the paragraph quoted above, Seligman argues

⁵ Stuart P. Meech, "Economic Aspects of Instalment Selling," *Journal of Business of the University of Chicago*, I (January, 1928), 68. Note the quotation marks around the word "savings."

that this "in that sense" saved income (i.e., psychic savings) results only if the consumer borrower's payments precede their utilization (using up) and not otherwise.⁶

He need not have made this limitation, for the consumer borrower has stored up psychic income whether his payments precede, coincide with, or follow utilization. In fact, psychic income exists while the commodity lasts even though he never pays for it. Seligman's error arises from his stated unwillingness to admit that a legitimate distinction exists between producer and consumer capital and his implicit acceptance of such a distinction. This leads naturally to the question of the relation of consumer credit to investment. The above discussion corroborates Seligman's main conclusion that consumer credit permits the consumer borrower to save, if by saving is meant stored-up psychic income. For society as a whole this is true only to the extent that the credit has caused more durable commodities to be bought than would have been purchased in the absence of the credit. Under the abstract conditions assumed here there is no basis for arguing one way or the other. As a historical long-run trend it is probable that consumer credit has had some influence in increasing the sale of durables. This is more fully discussed in the following chapter.

Saved psychic income can accrue to consumer borrowers only if other individuals have previously refrained from, or are simultaneously refraining from, spending their money incomes in full. In other words, saved psychic income resulting from borrowing presupposes money savings on the part of the nonborrowing segment of the community.⁷ The re-

mark of one of Seligman's followers that instalment-cash and instalment-sales credit do not, strictly speaking, check savings may be given proper perspective at this juncture. He amplifies by saying that such credit changes the form of the savings, which, instead of being put into productive equipment, are transformed into savings in kind.⁸ This represents a tacit admission that savings in kind are not the means to productive investment; on the contrary, they compete with productive investment for the available supply of the money savings of society.

Stated in other words, durable consumer capital bought on credit presupposes money savings by someone in the economy. These money savings, instead of being invested in productive capital, are invested in consumer capital. To the individual money saver either type of investment is productive in the sense of yielding a money income in the future. To the economy as a whole, however, only the money savings invested in producer capital represent productive investment. Thus for the economy as a whole saved psychic income⁹ competes with productive investment for the available money savings.¹⁰ Consumptive investment leads to capital formation in a much different sense from productive investment; to the

pression," *Annalist*, XXVII (January 8, 1926), 44; C. R. Noyes, "Financing Prosperity on Next Year's Income," *Yale Review*, XVI (January, 1927), 233; and Milan V. Ayres, *Instalment Selling and Its Financing* (Chicago: National Association of Sales Finance Companies, 1926), p. 6.

⁸ Harvey W. Huegy, "An Economic Analysis of Instalment Credit" (unpublished Ph.D. dissertation, University of Illinois, 1934), p. 103. It may be noted that savings in kind are what previously has been referred to as "psychic savings" or "saved psychic income."

⁹ Since saved psychic income is always embodied in consumer durable capital, this form of saving and consumptive investment are synonymous.

¹⁰ Frank H. Knight, "The Quantity of Capital and the Rate of Interest," *Journal of Political Economy*, XLIV (October, 1936), 618.

⁶ *Op. cit.*, I, 274.

⁷ In corroboration see, among others, J. H. Tregoe, "Time Payment Excesses Threaten De-

extent that consumptive investment exists, productive capital formation is retarded. This does not mean, as the classical economists and some of their followers have claimed, that consumer capital formation is socially undesirable. As discussed in chapters i and ii, each has its own justification, especially in an economy in which the standard of living is sufficiently high to warrant the presence of substantial amounts of durable consumer commodities not absolutely essential to physical existence. The difference between consumptive and productive investment is that one permits optimum spending through time of a given money income, while the other permits an increasing money income through time. Although both are significant in their own way, productive investment must dominate in a society if it is to remain capitalistic. This statement is based on the belief that such a society can exist only under conditions in which profits are possible. Profits are most likely under conditions of progress, and cumulative producer-capital formation, the cycle apart, is the *sine qua non* of such progress.

Seligman, it may be recalled, limits saved psychic income to the case in which the consumer borrower's payments precede his using-up of the durable commodity bought on credit. By so doing, he implicitly argues that the money savings have been freed for other uses and that the saved psychic income is a net gain for society as a whole. The error in such a position lies in the fact that future psychic income was substituted for (potential) future money income at the time the money savings were put in consumer capital rather than in producer capital.¹¹

¹¹ That psychic income may be increased at the time of borrowing over what it would have been had borrowing not been possible has been sufficiently emphasized in the preceding chapter and needs no further development here.

That fact cannot be changed, whatever the disposition of the money savings once they have been returned to the lender by the original consumer borrower.

Professor Plummer, unlike the writers previously cited, denies outright that consumer credit reduces the money savings available for productive investment. John Stuart Mill's argument to this effect is, he says, based on false assumptions. Plummer first claims that Mill ignores the fact that many articles bought with consumer credit are of the home-work-reduction variety and so release labor energy for other uses. Discussion of this point in the preceding chapter indicated that probably the bulk of the energy so released resulted in increased leisure rather than in more labor entering the exchange system.

To the extent that labor enters the exchange system and to the extent that it is due to consumer credit, Plummer's assertion might seem to be valid. However, on the negative side must be placed the decrease in productive energy caused by the diversion of money savings from productive to consumptive investment. Plummer seems to have foreseen this possibility, for he contends that Mill's position is valid only if it can be shown that in the absence of consumer credit the consumption would otherwise not have taken place, that is, that the money savings so diverted would have been used instead for productive investment.¹² This problem is one not so much of economic analysis as it is of the psychology of hu-

¹² Wilbur C. Plummer, "Social and Economic Consequences of Buying on the Instalment Plan," *Annals of the American Academy of Political and Social Science*, CXXIX (January, 1927), 14-15. In what follows it is assumed, except where otherwise noted, that productive investment opportunities are sufficiently great to absorb all money savings. While open to question under actual conditions, especially since Lord Keynes' recent work, it is valid under full-employment conditions. It should be noted that Plummer does not question Mill's assumption of full employment.

man behavior. Under conditions actually existing in the world and even under assumed theoretical conditions modern interest theorists, whether they belong to the time-preference, marginal productivity, or Keynesian schools of thought, argue that the extent of money savings of individuals rests on a number of factors.

Consumer credit, not being one of these factors, can have little influence on money savings in the present. Therefore, having once come into being, the money savings will be invested. In the absence of consumptive investment facilities these money savings would go entirely into productive investment, and the "consumption" would not have taken place. The term "consumption" is inclosed in quotation marks because, in so far as money savings are diverted to consumptive investment, the actual using-up of utilities by consumers in the income period of the diversion will not equal the funds so diverted. It is apparent that productive investment will result in increased future consumption. What happens in the absence of durable consumer goods is that a given amount of productive investment will support more consumption (using up) in any given income period.

Plummer makes much of the point that many users of consumer credit are at the same time also savers, that is, lenders for productive purposes. He concludes that consumers, by going into debt, abstain from using up their money savings and thereby prevent a lessening of the amounts available for productive investment. But what he omits from his analysis is the obvious point that, although the borrowers' money savings remain intact, those of other persons are deflected from productive investment to the extent of the borrowing. Therefore,

for the community as a whole, the funds available for productive investment are diminished by the amount of the consumer debt regardless of whether or not the debtors and savers are the same or different persons.

In conclusion, under the conditions assumed, the traditional view that consumption and productive investment are for society as a whole alternative choices has not been successfully challenged by writers on consumer credit. Consumer credit competes with producer credit for money savings, and, to the extent that consumer credit exists, the productive capital formation of the economy is reduced. Professor Haberler says that savings and investment may be defined either inclusive or exclusive of consumer durable goods. He admits that in either event the distinctions, supported throughout the present discussion, between money savings and saving in kind and between "productive" and "consumptive" investment are important and adds that both sets of definitions can be made to cope with them.¹³ The writer has no quarrel with this position but believes the narrower definitions are the least susceptible to errors of interpretation.

ALLOCATION OF RESOURCES

Some theoretical considerations.—Under conditions of perfect competition it is usually argued that at equilibrium resources will have distributed themselves in such wise that no further incentive to movement exists. Firms will be of optimum size and working at or beyond the low point on their average cost curves. Assuming an expanding economy, forces are constantly in motion making for reallocations of the factors of production.

¹³ Gottfried Haberler, *Consumer Instalment Credit and Economic Fluctuations* (New York: National Bureau of Economic Research, 1942).

These forces, depending on their nature, will influence production in a number of different ways. Of interest here is the effect on production of an increase in the use of consumer credit.

A somewhat artificial case may be proposed as the most convenient method of stating the problem and of leading up to the discussions found in the literature. It is assumed that consumer credit is increased at a definite rate, not by the diversion of money savings from productive investment, but by an increase of money savings. The question of whether or not this represents an earmark of an expanding economy may be postponed for the moment. Money savers by assumption are not the same persons as consumer borrowers. In so far as consumer borrowers have different tastes from money savers, and this will be likely, there will be a shift in demand among various commodities and some reallocation of resources. If the reallocation of resources does not take place smoothly, the industries affected may undergo price and employment difficulties which, if important enough, could affect the whole system. Here it is assumed that the shifts take place with the minimum of resistance.

If increased production results, it may be concluded that consumer credit has been the facilitating factor. It must be stressed that credit is assumed here to play the causal role in the shift of resources, more fundamentally in the shift of tastes within the economy. Since the resources both before and after movement are, by assumption, distributed in the optimum manner, increased production can obtain only if the firms to which the resources flowed are subject to long-run decreasing costs and the firms from which the resources came are not so subject or, if so, to a lesser extent. It is not

profitable to pursue the analysis further, since the result will be dictated by whatever assumptions are chosen. Similar conclusions hold if for perfect competition is substituted one of the myriad forms of imperfect competition.

Certain historical considerations.—The discussion may rather be turned in a historical direction. In the United States what has been the influence of consumer credit on the effectiveness of the allocation of resources? The preceding analysis has indicated clearly the two crucial questions which must be answered. First, are firms which sell consumer commodities on credit more subject to long-run decreasing cost than firms doing a cash business? Second, if so, has consumer credit been an important causal factor in the shift of consumption to the products of the credit firms? The two questions, considered in order, involve judgment on issues which are intangible at best.

In discussing the first question, a few remarks in review are desirable. Historically, open-account sales credit has not been particularly associated with any specific products. Instalment-sales credit and that part of instalment-cash credit used to make anticipated purchases have, on the contrary, been extended mainly in connection with commodities that are durable and high priced relative to the incomes buyers receive in each of their income periods. The last fifty years have witnessed a sharp rise in the amount of instalment credit outstanding. During this same period the prices of many instalment-sold products have fallen. If space permitted, a number of writers of more or less popular articles could be cited who take it for granted that the firms making instalment-sold products are peculiarly susceptible to large-scale production characterized by long-run falling costs. These writers also seem to

take it somewhat for granted that consumer credit has contributed to the growth of scale.

With little exception writers who consider the problem at length are more skeptical. It is convenient to use the analysis of Crick, one of the exceptions, as a focal point.¹⁴ Starting from the assumption of a stable real income, he argues that an increase in instalment-sales credit will initially curb either or both immediate consumption and money saving. He then abandons the assumption and looks at what he calls "the secondary effect of increased instalment selling," namely, more economical production.¹⁵ He argues that instalment credit will aid production only if real saving in the absence of such credit is proceeding too rapidly. Otherwise depression will set in. What is involved is the already discussed problem of capital formation. A few critical comments may be added here, however.

Although Crick speaks of depression, his analysis seems to be essentially long run and is so considered here. He does not define the term "real saving" but in the context would indicate that it refers to money savings embodied in productive assets. Assuming this interpretation is correct, if money savings are accumulating faster than they can be absorbed into productive investment, idle resources exist. But the existence of idle resources is inconsistent with full-employment analysis. Crick specifically talks in terms of long run; he reserves one special chapter for cycle problems. In his discussion of the long run there is none of

the thesis, later systematized by Lord Keynes, that oversaving leads to chronic (long-run) unemployment.

If by the term "real saving" Crick means the money savings embodied in all types of assets, his position becomes meaningless. On top of this he utterly fails to indicate any criteria for determining the ideal rate of saving. Professor Huegy interprets Crick's "real savings" concept to mean money savings and claims that he overemphasizes the concept. Of importance, according to Huegy, is the quantity and quality of real capital, not of capital funds. But shortly thereafter he argues that saving (money?) and capital (productive?) can proceed too rapidly only in the sense that the increase in money savings outruns the ability to put them to productive use.¹⁶ The incompatibility of the two sentences is self-evident.

Crick produces a second type of argument to show that instalment credit leads to more economical production. Instalment selling, being largely confined to durable commodities, necessitates a reduction in commodities currently consumed. This shift to durables he terms a refinement of consumption and argues that it invariably lowers costs through greater efficiency of the human factors in production.¹⁷ The doubtful validity of this point has been noted in chapter ii. Where the rate-of-saving factor works in the opposite direction from the refinement-of-consumption factor, Crick believes that the second factor will dominate because wages are the greater percentage of total costs.¹⁸ This reverses the

¹⁴ W. F. Crick, *Economics of Instalment Trading and Hire Purchase* (London: Isaac Pitman & Sons, 1929), pp. 65-73.

¹⁵ One of the main criticisms of Crick's argument is that he fails to specify the cause of the increased real income.

¹⁶ Huegy, *op. cit.*, chap. v.

¹⁷ Crick, *op. cit.*, p. 68.

¹⁸ Nugent interprets Crick to the effect that under conditions of a stable output increased instalment selling will reduce productive capital formation. To quote from Nugent: "He [Crick] believed, however,

usual argument that it is the industries with heavy plant costs which are most susceptible to economies of large scale.

Even granting lower costs in the instalment industries, Crick still has to show that they will not be counteracted by higher costs elsewhere. To him the noninstalment industries are not essential and/or are characterized by costs which are relatively unresponsive to demand. He gives beer and tobacco as examples. A quotation from Seligman, who, as already seen, is usually optimistic on most points touching instalment selling, is the best possible answer here: "Mass production is a characteristic of the entire field of modern industry, and it is to be observed as well in those cases where instalment selling is not practiced at all."¹⁹ Only thoroughgoing statistical studies offer the hope, and then but a slight one, of adding fresh information on the subject. Until that time a healthy skepticism that instalment industries are peculiarly subject to long-run, decreasing costs seems warranted.

The second question on page 50 above may, in the light of the intervening discussion, be rephrased as follows: Granted that both instalment and noninstalment industries are characterized by mass production, may it not, nevertheless, be true that instalment-sales credit exercises some influence in shifting purchasing power among industries? Many writers could be cited who admit such an influence somewhat uncritically. Although it would be false to deny consumer credit some influence, the writer contends that

that the same tendency would prevail under conditions of increasing output unless savings exceeded the 'ideal rate' " (*Consumer Credit and Economic Stability*, p. 157, n. 4). But this ignores the other factor, refinement of consumption, which always works in that direction and which is given the greater emphasis by Crick.

it may easily be and has been exaggerated. Fundamentally, instalment credit was called into being by the growth of durable goods and not the converse. The tremendous capacity of the automobile industry growing out of the first World War gave a strong impetus to the selling of automobiles on the instalment plan.²⁰ It is true that, once born, credit in turn encourages some persons to shift from nondurables to durables. In the nature of the case the extent of this secondary influence cannot be ascertained.

The author believes that extravagant claims arise partly because many writers look at only one durable-goods industry at a time. It is perfectly true that if one durable-goods industry does not rely on instalment credit whereas the others do, it will lose sales to them; the converse is also true. But, with all durable-goods industries following a similar practice, the effect of the credit will be less noticeable. A statistical study of the factors influencing the demand for automobiles gives but minor consideration to instalment credit.²¹ This is very significant in view of the dominant place the automobile holds in the instalment-credit field.

Several minor points may be treated together. The first concerns the effect of expansion credit on the preceding analysis.²² Assuming price and cost flexibility, such credit would cause a wider range of price changes and, to the extent that products differed in elasticity, would shift consumption in favor of those which were more inelastic. Further, if the credit

²⁰ Wallace P. Mors, "Theories of Consumer Credit" (unpublished Ph.D. dissertation, School of Business, University of Chicago, 1942), chap. ii.

²¹ C. F. Roos and Victor von Szeliski, "Factors Governing Changes in Automobile Demand," in *The Dynamics of Automobile Demand* (New York: General Motors Corporation, 1939).

²² Nugent, *Consumer Credit and Economic Stability*, pp. 152-53.

¹⁹ *Op. cit.*, I, 295.

were not distributed over the whole community, it would shift purchasing power toward the commodities preferred by the borrowing segment. Now for the first time credit also affects total money demand. Because there are no idle resources, however, the whole effect of the credit is exhausted in a rise of prices. Given sufficient price flexibility and the absence of uncertainty, neither inflation nor difficulties due to impediments in the shifting of resources among industries will result. The next chapter devotes more attention to expansion credit. Under the more realistic conditions assumed therein the effect of such credit becomes of much greater importance.

Nugent's brief attempt to fit fluctuations in consumer credit into the classical analytical apparatus is surely oversimplified. He argues that, when consumer credit increases, the prices of consumer durables will rise and resources will flow from producers' to consumers' goods and vice versa for a contraction of consumer credit.²³ Actually, those consumers' goods for which the demand increased and the producers' goods behind them would experience a price rise and conversely for the consumers' goods with a falling demand and their respective producers' goods. Further, an increase in saving in excess of the increase in consumer credit is entirely possible (especially if it is at all a function of the interest rate), making unnecessary the absolute crude shifts of resources postulated

²³ *Ibid.*

by Nugent. The complex relation between producer and consumer goods has never been satisfactorily worked out.

The effect of consumer credit on distribution, though probably small, is clearly in the direction of shifting purchasing power through time from the borrowing to the saving segment of the community by the amount of the finance charge. For reasons already indicated, the discussion in this chapter concerns only that part of consumer credit which is anticipated.

SUMMARY

The foregoing analysis on the whole supports the classical conclusion that consumer credit does not under theoretical conditions augment the production of an economy, that is, its real national income through time. To the extent that consumer credit permits those outside the exchange mechanism to do their work more efficiently, to the extent that the energy released becomes work time rather than leisure time, and to the extent that consumer credit shifts resources to industries peculiarly susceptible to long-run, falling costs, the conclusion must be modified. For the reasons already given, this modification, historically speaking, has probably been negligible. Against any increase in production from the above chain of events must be set the much greater production which would have resulted had the money savings been diverted instead to productive investment.

CHAPTER IV

CONSUMER CREDIT AND UNDEREMPLOYMENT CONDITIONS

THE present chapter is a critical analysis of the literature with respect to the effect of consumer credit on the economy's real national income under conditions of less than full employment of the factors of production. The major conclusion of the previous chapter that consumer credit does not augment production (consumption) through time under conditions of full employment has been held in some quarters to be substantially valid for those of underemployment as well. Even in this event the changed conditions require some modifications in analysis. The better point of view in the writer's opinion is that evidenced by the following quotation: "The classical analysis¹ of the consequences of consumer credit fluctuations is certainly tenable if and when the assumption of full employment of the factors of production becomes a reality. Under other conditions it leads to erroneous conclusions."² The discussion which follows attempts not only to support the quotation but also to indicate to what extent classical conclusions need modifications.

Conforming to the practice of writers on consumer credit, the author has given virtually exclusive attention to the relation of consumer credit and the business cycle.³ Although many have written on

the subject, the two book-length studies by Nugent and by Haberler easily dominate the field not only because of their length but, more important, because each makes a considerable contribution to knowledge. The procedure is followed of building the discussion around the works of these two writers and of referring to the contributions of other writers at appropriate points.

Lack of space prevents development of the well-recognized point that the business cycle is of fundamental importance in influencing consumer-credit fluctuations.⁴ Consumer-credit fluctuations in turn react on the cycle, and it is to this reaction that the following discussion is devoted. Of the factors mentioned in the preceding chapter through which consumer-credit movements may affect the real national income, only two—the behavior of demand and the supply of capital—need be discussed here. Discussion of the others would yield results similar to those previously reached.

Demand is a convenient starting-point. It will be argued that, in so far as consumer-credit movements either change total monetary demand, hereafter referred to as effective or aggregate demand, and/or cause shifts in the demands of consumers among commodities,

¹ The preceding chapter, it may be repeated, upholds classical theory.

² Rolf Nugent, *Consumer Credit and Economic Stability* (New York: Russell Sage Foundation, 1939), p. 164.

³ The effect of consumer credit on long-run and on seasonal underemployment is probably negligible. Few writers have discussed either problem. For a

critical résumé of their positions see the writer's "Theories of Consumer Credit" (unpublished Ph.D. dissertation, School of Business, University of Chicago, 1942), chap. vi.

⁴ For an extended treatment see *ibid.* Anticipated consumer credit, it may be remarked, moves cyclically; unanticipated consumer credit, counter-cyclically.

they may, but not necessarily will, affect the real national income.

A. AGGREGATE DEMAND

INITIAL OR PRIMARY STIMULATION OF AGGREGATE DEMAND

It was pointed out in the previous chapter that any increase in consumer credit not balanced by a similar increase in voluntary savings will increase effective demand. This could happen only if there were idle credit reserves in the system or if the economy experienced sharp, short-run changes in velocity. Neither would be usual under full-employment conditions. If either were the basis of an increase in consumer credit, this increase would exhaust itself in higher prices, leaving the real national income unchanged.

For this reason the subject was not pursued at length. Under cyclical conditions the behavior of the volume of credit assumes a much greater importance. For one thing, except at the peak of prosperity and sometimes even then, idle credit resources are a characteristic feature of the economy. In addition, velocity exhibits marked cyclical behavior. The use of these idle resources and/or, what is less likely by itself in practice, an increase in velocity, will stimulate effective demand. Given unutilized resources, the increased effective demand may increase production as well as prices.

The upswing is used for the most part as the pivot of the discussion. The question arises: Does the increased consumer credit which normally characterizes an upswing release otherwise idle reserves and, if so, does the resulting increase in effective demand translate itself into greater production and greater real national income through time? In fine, is consumer-credit growth reinforcing in its effect on the upswing?

One work would dispose of the whole problem with this contention:

In the upswing period consumer credit probably has little effect, certainly no predictable effect, on the total volume of credit in use. . . . If the funds that flow into consumer use were not put at consumer disposal, they would be absorbed by producers. . . . Consumers' expenditures out of income would be just as high, but sales of durable consumers' goods would be less and sales of producers' goods greater.⁵

Given our institutional arrangements, the quotation is open to a question of fact, especially in the early part of the upswing.⁶ Then the idle capacity of industry is great enough that considerable expansion is possible without new productive investment. Any consumer credit outstanding is just that much more credit than would be existent in its absence. Furthermore, as will be argued, borrowers might spend more in the borrowing period than they would in the absence of the credit without causing credit and hence spending contraction elsewhere. More fundamental, perhaps, the logic of the argument is doubtful. Even if producer credit were an ever present and willing alternative, this does not negate the fact that consumer credit exists or that it, and not its potential substitute, is the force to be studied. One might be tempted, wrongly so, to turn the argument around and to make consumer credit the substitute. One writer holds that most of the problems of instalment finance "can be subsumed under the general theory of money and credit."⁷ The whole of the present study

⁵ Charles O. Hardy (ed.), *Consumer Credit and Its Uses* (New York: Prentice-Hall, Inc., 1938), pp. 152-53.

⁶ Nugent, *op. cit.*, pp. 200-201.

⁷ G. Schwartz, "Instalment Finance: The Nature of Consumer Credit," *Economica*, III (May, 1936), 195.

must stand as a refutation of so extreme a position.

On the downswing the work edited by Hardy admits that any contraction of consumers' credit will tend to "pull down total income and accentuate the forces of depression."⁸ This is not inconsistent with the "alternative" argument of the upswing, for on the downswing there are clearly no alternatives present. In other words, as far as credit is concerned, the upswing and downswing of the cycle are not entirely symmetrical.

But may not the added consumer credit "cause" a proportionate contraction in spendable funds elsewhere in the economy and/or may not the borrower have spent a similar amount in the absence of the credit? On the whole, the answer in both cases is in the negative. This is implicit in the analyses of all those writers who argue that consumer credit advances money purchasing power, whether permanently or at the expense of future purchasing power is irrelevant here. Only Nugent and Haberler have specifically discussed the issue, and the material which follows is largely a summary statement of their remarks. As Haberler has indicated, the answer depends on the economic position of the borrower and lender both at the time of the extension of the credit and at the time of repayment.

The lending side may be dispensed with briefly. The excess idle reserves characteristic of the upswing and the fact that consumer lenders, in tapping these reserves, need not cause a contraction in loans elsewhere in the economy have already been indicated. There is no reason for believing the actualities are otherwise. Nugent elaborates here by noting that if access to idle reserves were not so ready, the agencies might finance

expanded consumer loans by withholding dividends from shareholders.⁹ In this event the increased (involuntary) savings on the part of shareholders would offset the new credits granted, and effective demand would not be augmented. Actually, because accepted accounting practice approves the practice of balancing quick assets against short-term obligations, consumer lenders may and do rely on the money markets. Hence "there has been a general tendency for [lenders] to finance expansions of their receivables by bank loans or by credits from wholesalers or manufacturers, which in turn finance their receivables by bank loans."¹⁰ The high elasticity of the money supply tends to fall as the recovery period advances, particularly if the banks are nearing the limit of their reserve ratios. That the limit will not invariably be reached is illustrated by the prosperity period which ended in 1929. The downswing is the converse of the upswing in one sense but not in another. The contraction of consumer credits outstanding is not offset by expanding loans elsewhere, but the process goes on regardless of the nature of the elasticity of the money supply. From the lending side alone it may tentatively be concluded that the increase in consumer credits on the upswing augments, and the decrease on the downswing contracts, effective demand. The borrower side still remains to be considered.

For the borrower the crux of the matter lies in what he would have done in the absence of the credit.¹¹ Effective de-

⁹ *Op. cit.*, p. 183. This tacitly assumes that the shareholders would have spent or invested the dividends if received.

¹⁰ *Ibid.*, p. 184.

¹¹ For a classification of all the possibilities see Gottfried Haberler, *Consumer Instalment Credit and Economic Fluctuations* (New York: National Bureau

⁸ *Op. cit.*, p. 153.

mand is increased when the new credit is extended only if it leads to buying which otherwise would not have been undertaken. Effective demand is reduced by repayment only if the sums repaid would in the absence of the credit have been used for current spending. In other words, to the extent that the borrower uses consumer credit as a convenient substitute for the withdrawal and repayment of savings, consumer-credit movements are without influence on effective demand.¹² There are several reasons for believing that such is not entirely the case.

A large number of consumer borrowers have no accumulated savings on which to draw. This is supported by data showing that individual savers are concentrated more heavily in the upper-income groups than are credit users.¹³ Second, there is no assurance that all those consumers who have money savings would, in the absence of consumer credit, be willing to use their savings for spending. Haberler sums up the case very nicely by noting that many savings, such as insurance policies, are in an illiquid form or, if not, would entail considerable cost to liquidate.¹⁴ Over and above that is the much-mentioned point that, even if

neither were true, "many who buy on credit would be unwilling to withdraw their savings in order to pay cash for the same goods."¹⁵ This seemingly somewhat irrational behavior arises essentially from the fact that such consumers think of savings as a "long-run" phenomenon and of credit as a "short-term" phenomenon. That is, consumers regard savings as a bulwark against emergencies or as part of a systematic means of providing for the future.

Concerning those consumers without money savings it may further be asked: Would their use of credit have less effect upon aggregate demand if it could be shown that in the absence of the credit they would have saved ahead to buy the corresponding commodities? The writer gets the impression, perhaps mistakenly, from Haberler's analysis that the answer should be "Yes." Haberler discusses the point in the same section in which he covers the matters mentioned in the paragraphs above. He argues at some length that actually many of those without savings lack the will-power to save ahead, while others who would refuse to pay the entire price at the time of the sale cannot resist the temptation to buy on the instalment plan. These two allegations have been repeated many times and, on the basis of observation, are accepted here as valid without further comment.

It is the writer's contention that whether the consumers in question would, in the absence of credit facilities, save ahead or not is largely irrelevant to

of Economic Research, 1942), pp. 187-89. Only the ones most likely to be realized in practice are covered in the text.

¹² Nugent, *op. cit.*, p. 185.

¹³ For savings data by income groups see Temporary National Economic Committee, *Savings, Investment, and National Income* (Monograph No. 37 [Washington, D.C.: Government Printing Office, 1941]), p. 15. For similar data on instalment-credit users see John M. Chapman, *Commercial Banks and Consumer Instalment Credit* (New York: National Bureau of Economic Research, 1940), pp. 64-68, and Blanche M. Bernstein, *The Pattern of Consumer Debt* (New York: National Bureau of Economic Research, 1940). The last study also covers open-account debt.

¹⁴ *Op. cit.*, pp. 45-46.

¹⁵ Nugent, *op. cit.*, p. 185. For earlier mention of this point see, among others, Wilbur C. Plummer, "Social and Economic Consequences of Buying on the Instalment Plan," *Annals of the American Academy of Political and Social Science*, CXXIX (January, 1927), 15, and George Filipetti, "Consumer Credit the Hope (?) of the Producer," *Management Review*, XVIII (March, 1929), 77.

the problem of the effect of consumer credit on aggregate demand. What is important is simply whether, in using credit, consumers are spending funds which *at the time* would otherwise not be available to them—funds, furthermore, which would not have been spent concurrently by other persons under any conditions. A similar statement holds for those who have savings which they are unable to liquidate. Only for credit users with liquifiable savings is the case somewhat different, for they could, in the absence of the credit, still spend if they wished to draw on these savings. Whether this would push effective demand up would depend on whether or not the savings were being actively used at the time of withdrawal.

Nugent observes that even for consumers with savings "the pattern of expenditures would probably change substantially if consumer credit facilities did not exist."¹⁶ If anything, the absence of consumer credit would lower aggregate demand on the upswing and increase it on the downswing. This conclusion is based on the inference that consumers would then become "more sensitive to price changes and to the need for replacements and less sensitive to the trend of incomes."¹⁷ Working in the same direction is the fact that if consumers saved ahead, it might become difficult to invest savings for only the short period during which the savings were being accumulated. This would be true particularly of the early stages of the upswing and of the whole of the downswing—periods characterized by a "shortage" of productive investment opportunities. Even if invested, the early withdrawal of such savings could cause considerable friction. Haberler has criticized Professor Schumpeter's position that such accumu-

lations should not be considered savings in the usual sense of the term on the grounds that the savers may change their minds before the actual spending takes place and invest the savings instead.¹⁸ The difficulties of interim investment alluded to above and the little likelihood of many persons changing their minds incline the writer on practical grounds to agree with Schumpeter. The remarks in this paragraph apply equally to nonsavers who have the will-power to save if necessary.

The repayment side of the transaction must be looked at next. Haberler, the only one to discuss the problem explicitly, believes that, on the whole, consumers reduce their current spending rather than their current saving in order to repay consumer debts.¹⁹ This is certainly the case with respect to non-money-savers. Even for savers, savings programs are often inflexible, owing to institutional arrangements—witness life insurance and pensions. The further possibility of selling assets is limited because consumers either do not have any or do not wish to sell them to liquidate debt.²⁰ The only assets which most consumer borrowers own directly come under the head of consumer capital. It would hardly be sensible for consumers to sell the assets they purchased on credit, or other assets for that matter, in view of the low prices which secondhand consumers' goods command. Certain writers have used the fact that some consumer borrowers possess equities upon which they can draw to support the conclusion that repayments will not necessarily contract current spending.²¹ This may be true in isolated cases (Haberler notes it as a possibility),

¹⁸ *Op. cit.*, p. 188.

¹⁹ *Ibid.*, p. 46. From Nugent's general analysis it is clear that he subscribes to a similar position.

²⁰ Cf. Filippetti, *op. cit.*, p. 77.

²¹ *Ibid.*

¹⁶ *Op. cit.*, p. 185.

¹⁷ *Ibid.*, p. 186.

but it does not seem defensible as a generalization.

There is no reason for believing that nonborrowing consumers, nonfinancial business firms, or governments will, as a consequence of consumer borrowings and repayments, counteract consumer-credit movements by changes in their spending-saving patterns. Any independent changes emanating from these three sources which act as accidental counteragents are purely fortuitous and have no relevance to the problem under discussion.

The general conclusion follows, then, that, given an elastic credit supply, aggregate demand is increased when new consumer credits outweigh repayments. This characteristically takes place during the upswing period of the cycle. When, as on the downswing, repayments exceed the new credits granted, aggregate demand is decreased; here the added proviso of an elastic credit supply is not necessary. In other words, consumer-credit movements are independent income-increasing and income-decreasing forces in the economy. Owing to the finance charge, the net new credits granted on the upswing will not, as a rule, increase effective demand quite by the amount of these credits.²² To do so it would be necessary for funds equivalent in amount to the finance charge to be exchanged against commodities at the time of the loan. This could be done if lenders paid such funds out either as business expenses or as dividends; in either event the lenders themselves would have to borrow, since the funds are not completely available to them until their borrowers in turn pay their loans. The likelihood of this happening is small. Lenders could also make new loans equal to the finance charge; in addition to the

above comment, a more serious deterrent here is the fact that this gives rise to an endless chain, since the new loans in turn include finance charges. On the downswing the net excess of repayments contracts effective demand in an equal amount. This could conceivably be offset somewhat by lenders purposely maintaining their staffs and/or dividend payments in the face of losses. To what extent either is done cannot be said. In the recent depression the scattered evidence available indicates that few lenders suffered losses. In any event, these reservations do not materially affect the general conclusion reached earlier in this paragraph.

The conclusion may also be extended to that part of unanticipated credit used to cover emergencies.²³ Practically speaking, emergency credit, because of its countercyclical behavior, works in the opposite direction from anticipated credit in its effect on aggregate demand. That part of unanticipated credit used to pay already existing debts stands upon a somewhat different footing. Whether it influences effective demand or not depends on what the creditor does with the money he receives from the refunding borrower. If, as is probably the general rule in depression, the creditor hoards the money repaid, the transaction produces no buoyant effect on aggregate demand. Aggregate demand is increased only by subsequent spending. But such a possibility is not limited to money borrowed to pay old debts. Since the matter is discussed later, it is not pushed further at this juncture.

EFFECT OF PRIMARY STIMULATION OF AGGREGATE DEMAND

On the upswing, then, consumer borrowers stimulate effective demand in

²² Haberler, *op. cit.*, p. 39.

²³ Nugent, *op. cit.*, p. 180.

spending the sums borrowed; this may be termed the primary or direct effects of consumer credit and is indicated statistically by a net credits change series.²⁴ Earlier writers talk in terms of increased (money) purchasing power rather than in terms of augmented effective demand, but this is merely a difference in terminology.

The result may, as under full-employment conditions be merely to raise prices. A second possibility, given unused resources of the right type and conveniently available, is increased production, alone or in combination with a price rise. On the basis of his study of the literature, Nugent correctly states that "it was generally conceded that in the short run an expansion of instalment credit would lead to increased production."²⁵ The conclusion holds for consumer credit in general.

Production would fail to increase only if firms had such large inventories that they were able to use these inventories to fill the additional orders induced by the net increase in consumer credit. This would be a fortiori true if firms kept the money so received as idle cash balances. The probability of excessive inventories is greatest near or at the bottom of the depression. A somewhat tentative point, suggested by the analysis of Harwood, may be made here with reference to durable goods. He notes as one of the cyclical dangers of instalment selling the fact that it builds up inventories in the hands of consumers and so makes possible the postponement of further purchases.²⁶ In

so far as the inventories which firms carry are thereby lessened, the production-increasing effect of instalment-sales credit on the upswing would be augmented. The hand-to-mouth buying tendencies which firms have followed since World War I, although independent of consumer-credit developments, have also worked in the direction of reducing normal inventories carried.

CUMULATIVE STIMULATION OF AGGREGATE DEMAND

More debated is the question of whether or not the increased production is at the expense of, or in addition to, future production. In other words, does increased consumer credit merely advance purchasing power through time or augment it? The latent assumption in this form of the statement is that the purchasing power translates itself into production. Nugent insists that admitting the possibility of purchasing power's becoming the independent variable and production the dependent one, whether in the short or in the long run, is a denial of classical theory, which asserts "not only the identity of purchasing power and production, but also the decisive position of production in the equation."²⁷ In the writer's opinion this should not, as Nugent insists, be construed as a criticism of the classical school, since its members were concerned primarily with long-run, full-employment conditions.²⁸ Under such conditions the position indicated in the quotation is correct.²⁹

To return to the point at issue, that

²⁴ Haberler, *op. cit.*, pp. 75-76. This is true given the assumptions on consumer spending and saving behavior in relation to credit use developed earlier in this study. A new credits or a repayments series would be more appropriate under other conditions. Such conditions are less likely to be realized in practice and so do not warrant extended discussion here (*ibid.*, p. 73).

²⁵ *Op. cit.*, p. 168.

²⁶ E. C. Harwood, "The Real Inventory Problem of Business Today Is the Consumer's Inventory," *Annalist*, XXX (October 28, 1927), 659.

²⁷ *Op. cit.*, p. 169.

²⁸ Alvin Hansen, *Business Cycle Theory* (Boston: Ginn & Co., 1927), pp. 23-24.

²⁹ For corroboration by Nugent himself see *op. cit.*, p. 164.

view is sound which holds that increased consumer credit may (we are dealing here with theoretical possibilities rather than necessary actualities) augment production through time. Not until the recent works by Nugent and Haberler has this view been supported by an adequate analytical apparatus. Alvin Johnson, probably the first writer to defend the position at all seriously, was content to state: "The net economic effect remaining [after increased instalment-credit transactions have cleared themselves] is an important addition to the goods at the command of society created by resources that would not have been so fully utilized if instalment buying had not existed."³⁰

Seligman asks, among other questions, "Is it not a fact that in the long run, at least, production and purchasing power are correlated?"³¹ From this rhetorical question comes the conclusion that instalment credit "does not simply advance purchasing power but may augment purchasing power."³² Seligman seems to anticipate Danielian's criticism of the rhetorical method of reaching a conclusion by placing major emphasis on another type of argument, namely, that instalment-sales credit stimulates the productivity of those using it.³³ The weaknesses of such an argument have already been exposed.

³⁰ "No Danger in Instalment Buying," *New Republic*, XLVI (April 28, 1926), 305-6. For a more tentative statement see John M. Clark, "Control of Trade Practices by Competitive and Other Forces," *Proceedings of the Academy of Political Science in the City of New York*, XII (January, 1927), 106-7.

³¹ Edwin R. A. Seligman, *Economics of Instalment Selling* (New York: Harper & Bros., 1927), I, 280.

³² *Ibid.*, p. 283.

³³ N. R. Danielian, "Theories of Consumers' Credit," *American Economic Review*, XIX (September, 1929), 405.

Other equally unsatisfactory arguments have been advanced. According to one, the borrower may experience a rise in income in succeeding periods. Unless this rise is due to consumer credit, the point is irrelevant. According to another argument, future purchasing power will not be reduced if the debt is paid off within a given income period or if the borrower has equities on which to draw. The first assertion is beside the point, and the second is valid only if the presence of credit causes the borrower to use his equities. That this is probably the exception rather than the rule has already been indicated. Last of all, it is alleged that consumer credit may shift demand to decreasing cost industries. The tenuousness of such a position has likewise already been shown. Lack of space prevents citing the writers who take one or more of the above positions.

Nugent lays the lack of an adequate analytical apparatus to the unsatisfactory state of dynamic theory—a state which, he says, has been rectified since 1936 by the work of Kahn and of Keynes. Without passing final judgment on this assertion, it should be pointed out that cycle theory was sufficiently developed in the 1920's and early 1930's to support the conclusion that consumer credit may augment purchasing power and production through time. The acceleration principle had long since been developed by Aftalion, and the volatility of bank credit was an integral part of cycle theory. They, together with the generally accepted point that consumer credit increased purchasing power (effective demand) in the short run, would have been sufficient to support the above conclusion.³⁴ It is true that the multiplier, then

³⁴ See John M. Clark, *Strategic Factors in Business Cycles* (New York: National Bureau of Economic Research, 1934), pp. 45-46.

unknown, represents a powerful new analytical tool, one which Nugent uses very effectively.

In addition to its primary effects, Nugent notes that an increment of consumer credit may further increase effective demand if subsequent recipients spend the funds on consumer goods (secondary effects) and/or if these recipients use the funds for productive investment (tertiary effects). The tertiary effects represent the workings of the acceleration principle or the "relation," as it has elsewhere been designated.³⁵ The ratio of the total rise in the national income to the increment of consumer credit and the productive investment caused by it is the multiplier. Nugent concludes that, to the extent that secondary and/or tertiary effects result, "the flow of incomes and production will continue at the accelerated rate." To the extent that the original increment of consumer credit "is absorbed by individual savings without a compensating increase in stimulating outlays in other sectors, the increment will dwindle and disappear."³⁶

Assuming that the funds keep turning over until the original debt is retired (i.e., there are no leakages), Haberler has shown that the total effects of the credit on the national income are best measured by a credit-outstanding series.³⁷

Nugent adds the significant statement that, because savings may be expected to increase absolutely as incomes increase, "the fate of the initial increment in income funds induced by expansion of consumer credit will depend to a large extent on the reaction of producers' investment to the increase in incomes."³⁸ He

believes that the increased demand for goods will increase the marginal efficiency of capital. "Thus, through its tertiary effect upon producers' investment, an expansion of consumer credit may create the means of absorbing the additional savings that may be expected to result from an increase in incomes and may even induce a cumulative expansion of incomes."³⁹ In other words, consumer credit may increase the supply of producer capital. This contrasts sharply with full-employment conditions, as discussed in the foregoing chapter. The preceding analysis reinforces the point made in chapter i that consumer credit is most likely to result in a sustained increase in the real national income through its ability to influence productive investment.⁴⁰

If the credit produces only secondary effects, it can increase production (the real national income) only to the limit permitted by the existing supply of the factors (especially capital) and the existing state of technology. The fact, as Nugent indicates, that some of the added money incomes will be saved reduces greatly the possibility of reaching this limit unless productive investment is encouraged.⁴¹ In that event, the limit may not only be reached but surpassed. Here is an important and often overlooked similarity between full-employment and underemployment analysis. In both cases productive investment is the *sine qua non*

³⁹ *Ibid.*, p. 187.

⁴⁰ The models of Paul Samuelson verify the importance of the "relation," as he calls it. He uses government credit, but similar results hold for consumer credit.

⁴¹ For a discussion of the point that to be successful a public works program must induce private investment see Arthur Gayer, *Public Works in Prosperity and Depression* (New York: National Bureau of Economic Research, 1939), pp. 370-71. Although not a perfect analogy, since artificially expanded consumer credit is not at issue here, it is nonetheless relevant.

³⁵ Paul Samuelson, "Inter-action of the Multiplier and Acceleration Principles," *Review of Economic Statistics*, XXI (May, 1939), 75-78.

³⁶ *Op. cit.*, p. 186.

³⁷ *Op. cit.*, p. 76.

³⁸ *Op. cit.*, p. 186.

of a permanently advancing real national income. The difference is that, with underemployment, this increase may come about through consumer credit, since it may stimulate productive investment; given full employment, consumer credit cannot have such an influence.

IMPLICATIONS OF THE FOREGOING FOR THE PROBLEM OF CYCLICAL FLUCTUATIONS

It is clear that this analysis leads to the conclusion that consumer-credit movements theoretically act as reinforcing factors both on the upswing and on the downswing. Although he furnishes no analytical apparatus, Plummer is thus correct in stating that in the later stages of the boom and in depression instalment (all anticipated consumer) credit would have the same effects as producer credit, that is, as credit in general.⁴² Further, it is possible for such movements to influence the major turning-points in the cycle. This is what Haberler means in stating that, although the general business cycle is the cause and consumer credit the effect, consumer credit may in turn react on the cycle.⁴³ The major difference between him and Nugent—a difference often met throughout the literature—concerns the quantitative and qualitative importance to be attached to consumer-credit movements. Haberler is very cautious in saying that our knowledge is yet insufficient.

Quantitatively, Haberler points to the relative smallness of the net credit change compared to the national income in the period 1929-40; he admits that the total influence, as indicated by credits outstanding, may have been greater, but he refuses to pass final judgment on the extent of this influence.⁴⁴ As to the turn-

ing-points, he reaches the negative conclusion that, "even though the curve of total instalment credit outstandings does not precede (but rather tends to lag a little behind) the turn in general business cycles, it is not possible to say definitely that instalment credit has not been an active force in bringing about the turn in business."⁴⁵ He adds that in the last four downturns government financing far overshadowed consumer credit. By "qualitative deficiencies" he presumably refers to lack of knowledge of the effect of consumer credit on the direction of changes in business fluctuations, that is, on the spending-saving patterns of borrowers and on the spending and investing habits of individuals and firms receiving funds from original borrowers.

Although neither he nor other writers explicitly discuss the upturn, the likelihood is small, practically speaking, that it will be initiated by an expansion of consumer credit, for an increase in consumer credit is usually itself a product of the recovery.⁴⁶ This statement abstracts from artificially induced consumer-credit expansion, a means of stimulating recovery which has been suggested in several quarters. Discussion of such plans is beyond the scope of the present study, but, in general, they raise problems not dissimilar to those arising from a public works program.

Nugent leans to the view that consumer-credit expansion was one of the prime causes underlying the prosperity period of 1923-29 and that consumer-credit movements have played a prominent role in subsequent fluctuations of business.⁴⁷ He specifically recognizes that

⁴⁵ *Ibid.*, pp. 141-42.

⁴⁶ Roy Westerfield, "Effect of Consumer Credit on the Business Cycle," *Annals of the American Academy of Political and Social Science*, CXCVI (March, 1938), 108.

⁴⁷ *Op. cit.*, chap. viii.

⁴² *Op. cit.*, pp. 42, 47.

⁴³ *Op. cit.*, p. 133.

⁴⁴ *Ibid.*, pp. 140-41.

part of the influence in the 1923-29 period was due to the tremendous structural growth of consumer credit; there is no way at present of statistically separating the structural and the cyclical elements. One of his reviewers believes that he has perhaps been guilty of some exaggeration.⁴⁸ Another reviewer argues that consumer-credit movements, as Nugent defines them, are less important than consumer decisions which affect the supply of currency and bank deposits held by nonconsumers.⁴⁹ It is beyond the scope of this study to attempt a settlement of this general problem; the weight of opinion is definitely on the side of admitting consumer-credit fluctuations to a place of minor influence in their effect on the cycle. This does not preclude an enhanced importance in the future.

A theoretical point raised by Professor Hart warrants attention. Nugent notes that the consumer debt outstanding, even in peak periods, is but a small percentage of the total debt outstanding. He claims that such a comparison is not valid for purposes of assessing the influence of consumer credit on the cycle; rather it is the magnitude of consumer-credit fluctuations compared with other "phenomena which have the capacity to induce expansion or contraction of incomes" which is important. The greater the relative size of consumer-credit fluctuations, the greater will be their stimulating or depressing effect.⁵⁰ Hart objects, stating that "the level of consumer credit outstanding is a factor in cyclical analysis along Keynesian lines."⁵¹ If by

this he means merely that the secondary and tertiary effects cannot be neglected, no comment would be necessary other than to say that Nugent probably assumes that the importance of these effects grows with the size of consumer-credit fluctuations.

Hart's objection is quite otherwise. He states that, by accentuating savings and reducing investment opportunities, consumer credit exercises a countercyclical influence (not, of course, sufficiently great to offset the positive effect of consumer credit fluctuations) the importance of which grows with the level of consumer credit outstanding. He reaches this conclusion by arguing that, when consumer credit is constant, the investment flow tied up in consumer goods equals the flow of savings "sucked from the consumer by his consumer credit obligations"⁵² and hence does not absorb any savings which otherwise would be made. "On the other hand, this investment flow does use up investment opportunities which would otherwise absorb savings."⁵³ To illustrate, he cites the example of the increase in automobiles reducing investment opportunities in street railways. The error in this type of reasoning lies in neglecting to inquire how the stock of cars was built up. The use of consumer credit to buy automobiles does not per se provide the means whereby the automobile companies can produce. Unless they already have excess capacity, a point seemingly not at issue,⁵⁴ it will be necessary for the automobile companies to increase their capacity through pro-

⁴⁸ Charles O. Hardy, in *Annals of the American Academy of Political and Social Science*, CCXVII (September, 1941), 192.

⁴⁹ Albert Gailord Hart, in *Journal of Political Economy*, XLIX (February, 1941), 130-31.

⁵⁰ *Op. cit.*, p. 190.

⁵¹ *Loc. cit.*, p. 130.

⁵² The size of the saving relative to the amount of investment will, he alleges, be greatest at the peak and lowest at the trough, thus exercising the countercyclical influence already noted.

⁵³ *Ibid.*

⁵⁴ Given excess capacity, it is likely that the effects of the consumer credit would be exhausted rather rapidly.

ductive investment; they may do this either through productive borrowing or through withholding profits. As Haberler mildly remarks, one must beware of double counting. He adds that if new consumer credits expand consumer spending and repayments contract spending, this automatically increases and checks producer spending in those lines, respectively, in which consumers buy and in which they reduce buying in order to meet the repayments.⁵⁵

A CRITICISM OF NUGENT'S ANALYTICAL APPARATUS

Although Nugent's conclusions, theoretically speaking, are sound, a part of his analytical apparatus is open to criticism. Already discussed is his point that, for effective demand to be increased, the added consumer credits granted must not be offset by a decrease in spending elsewhere in the economy. To this he adds a second prerequisite, at least for consumer credit "invested" in durable goods, namely, that the "investment must be treated as a capital outlay. It is the fiction of accounting and not the real flow of capital goods which provides income-increasing effects."⁵⁶

The writer contends that, at best, Nugent's second condition is superfluous and, in line with Occam's razor, may be dropped and, at worst, is misleading. *Reductio ad absurdum*, the second condition means that consumer credit (or producer credit for that matter) could not increase effective demand in a system in which firms and consumers kept their accounts on a "cash" basis. But in such a system, if idle cash resources were present, either within or without the banking mechanism, it would be perfectly possible for the holders of these resources to

lend them to consumers to permit them to purchase (invest in) durable goods—goods which otherwise would not have been purchased at that time.

Conversely, if there are no idle credit resources in the economy, consumer credit can have no influence on effective demand regardless of the accounting systems followed by consumers and firms. Since firms more commonly use the accrual system, since Nugent uses producer credit to illustrate his position, and since the point at issue is independent of the type of credit involved, further discussion will be centered about productive investment by firms. To elaborate his stand, he notes that, "by means of the device of charging investments to capital account, total outlays during a given period may exceed total receipts without conflicting with orthodox budgeting principles, and these increased outlays become the incomes of the factors of production in the succeeding period."⁵⁷ But does this divergence depend on capitalization? Nugent supplies his own answer. A few pages earlier he had explained that the real national income is determined by expenditures on consumption and investment—in fine, by effective demand.⁵⁸ Then came two sentences of great significance for the present discussion:

Nominal national income is the sum of the outlays of entrepreneurs to the factors of production, including the positive or negative incomes (profits or losses) of entrepreneurs. If income recipients as a whole spend or invest their entire income—that is if savings and investment are equal—nominal national income will be fully translated into effective demand, and the receipts of entrepreneurs will equal their outlays.⁵⁹

Thus the initial or primary effects of credit on aggregate demand depend en-

⁵⁵ *Op. cit.*, pp. 46-47.

⁵⁶ *Op. cit.*, p. 178.

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*, p. 173.

⁵⁹ *Ibid.* (Italics mine.)

tirely upon the existence of idle money (credit resources) and not upon capitalization; for capitalization is surely present in a system in which savings equal investment (or in which total outlays equal total receipts), and yet investment is then incapable of producing an increased aggregate demand. A similar criticism holds if secondary and tertiary effects are included, for, as one reviewer puts it, "the effect on the income of the other factors of production is independent of the bookkeeping of the investors, and a rise in the price of the product is irrelevant to the question whether total income in money terms will rise."⁶⁰ The bookkeeping arrangements affect not the size of the income but its distribution among the factors.

Nugent himself seems to be somewhat aware of this, for he says in a footnote that "the two conditions upon which the stimulating effects of investment depend are, in fact, identical in terms of the real flow of goods."⁶¹ Further, when he turns to consumer outlays used to meet emergencies or to cover current household expenses, he says specifically that, to stimulate effective demand, such outlays must be financed by borrowing, that is, by recourse to otherwise idle funds.⁶² This is the only requisite regardless of the manner in which the credit is spent.

SUMMARY

On the upswing, consumer credit increases effective demand, which, in turn, stimulates production and the money incomes of the factors of production. In so far as the factors spend the money so received, they further augment effective demand and production; in so far as some of the money is productively in-

vested, it is the means of absorbing any savings resulting from the increased money incomes and also the means of supporting a further expansion of production and money incomes. The reverse process takes place on the downswing. Consumer-credit fluctuations through their cumulative effect on the real national income may theoretically reinforce the cycle both up and down. In addition, "it is certainly possible to derive an initiating influence on the cycle from theoretical analysis."⁶³ The actual importance of consumer-credit movements on the cycles of the past several decades is a matter of controversy but is probably small. This does not affect the validity of the theoretical conclusions.

Argument that consumer credit does not augment the real national income.—There is another, until recently the dominant, point of view to discuss, namely, that which holds that on the upswing increased consumer credit does not augment but rather merely advances production (the real national income) through time. The greater emphasis by some writers on the deflationary effects of consumer credit on the downswing might give the impression that consumer credit works cumulatively in one direction only.⁶⁴ However, in the lack of more precise statements, it may be assumed that the downswing is the converse of the upswing, namely, that the falling production is not made greater but is merely pushed forward in time by the decline in consumer credit outstanding.

A reproduction of the typical analysis will make the position more clear; the upswing again may be used as the focal

⁶³ Nugent, "Consumer Debt and the Business Cycle," in *Financing the Consumer*, ed. John H. Cover ("Journal of Business Studies in Business Administration," Vol. VII, No. 4 [Chicago: University of Chicago Press, 1937]), p. 12.

⁶⁴ Westerfield, *op. cit.*, p. 109.

⁶⁰ Hardy, *loc. cit.*, p. 192.

⁶¹ *Op. cit.*, p. 180.

⁶² *Ibid.*, pp. 180-81.

point. Let us assume that an individual has a monthly income of \$150, all of which he spends. His purchases may be increased above that amount in any one month by borrowing. Supposing that his credit limit is \$75, then in the month of borrowing his purchases increase to \$225. But, if he pays back the amount in the next month, his purchases reduce to \$75. The total for the two months is \$300, whether he borrows or not. (Similar results would be achieved by extending the borrowing and/or repaying period.) Likewise the total production for the two months is the same in either event; only its timing is changed. Unless the borrowing could be increased indefinitely, the result could not be otherwise. As one writer puts it, consumers cannot spend next year's incomes this year and still expect to spend the same incomes again next year.⁶⁵ This leads to the general conclusion that "consumer credit avails little in increasing total consumption [production] through time."⁶⁶ The conclusion is unchanged by the fact that the consumer borrower's income increases during the borrowing period if the increased income is independent of the use of the credit.⁶⁷ It may be noted parenthetically that it is the borrowing capacity of the individual consumers, taken one at a time, and not the lending capacity of the banking system which is at issue here.

If the credit increases the borrowers' or other persons' incomes, the argument takes on a different hue. This has already been indicated at length in the preceding

⁶⁵ C. R. Noyes, "Financing Prosperity on Next Year's Income," *Yale Review*, XVI (January, 1927), 239.

⁶⁶ Westerfield, *op. cit.*, p. 108.

⁶⁷ Thomas Nixon Carver, "Consumer Credit and Economic Instability," *Annals of the American Academy of Political and Social Science*, CXCVI (March, 1938), 97.

pages of this chapter. The writers now under consideration simply deny that the increased credit will enhance the money incomes of those who use it. This may well be true, but what about the money incomes of nonusers? Since it is generally admitted that production will be increased in the short run, does not this mean an increase in the money incomes of the factors? The answer must be "Yes" unless firms are able to increase production with existing, partly unused factors to whom they do not have to pay greater remuneration, and then only if firms' dividends are not affected by the increased receipts. In terms of aggregate demand the increased consumer credit in this case exercises primary effects only. A similar conclusion holds if new factors are employed who hold idle the money incomes received. The presence of laborers among the added factors renders such a possibility unlikely.

The weakness of this school of thought, then, is in stopping with the original borrower and in neglecting to inquire into what happens to the funds after they leave the borrower. In other words, in admitting that increased consumer credit augments production in the short run, this school fails to make clear how that can come about without increasing the money incomes of the factors of production or, if so, how the factors must dispose of the added money incomes without influencing future purchasing power and production. This can be shown, to repeat, only by assuming that the credit is restricted in its influence, to primary effects on aggregate demand, that is, the borrowed funds leak completely out of the system after being spent originally.

In discussing the cycle, writers of this school of thought argue that consumer credit exercises a cumulative, reinforcing effect both up and down. For example,

Westerfield notes that on the upswing the effect of consumer-credit growth is "to accentuate somewhat the rise . . . in trade and industry."⁶⁸ Moffatt had previously noted that instalment credit, by making an upward trend appear more favorable than can be maintained in the future, gives an upward impetus to the cycle.⁶⁹

These conclusions are similar to those reached by the school to which Nugent belongs. It apparently makes little difference in assessing the effect of consumer credit on the cycle whether the credit enhances or merely advances production through time. However, this glosses over real difficulties which have not been explicitly discussed in the literature. One difficulty is the interpretation of the phrase "production or real national income advanced rather than augmented through time." Presumably, the phrase means that from trough to trough or from peak to peak total production in physical terms will be the same whether or not consumer credit is present in the system. The fact that the types of goods will be different in the presence and absence of consumer credit brings up the problem of measuring two bundles of different combinations. Though real, the problem may be brushed over here by assuming that measurement is feasible.

If total production through one cycle is to remain unaffected, consumer-credit fluctuations must not influence the length of the period from peak to peak. A given size production in, say, x years is not equivalent to the same size production in x -plus years. Assuming complete leakage (as already indicated, the writers now under consideration tacitly

make such an assumption), credit will be devoid of such influence only if credit sales do not have earlier turning-points than do cash sales.⁷⁰ In other words, increased credit must depend upon, and coincide in time with, an increase in production. This makes consumer-credit movements completely dependent in timing on the main cycle. It follows that consumer-credit movements can then have no influence on the cycle's major turning-points. Actually some writers in the school now under discussion agree with the preceding statement but for an entirely different reason, namely, the relative insignificance of consumer credit.

It would be mathematically possible for consumer credit to affect the amplitude of the cycle in a given time period and yet leave the size of production from peak to peak unchanged. If, as the writers above cited indicate, consumer credit accentuates the prosperity, then, to balance, the succeeding depression must be that much worse.⁷¹ (An analogy, perhaps, is the action-reaction theory of the Babson organization.) This can actually come about, however, only if, as production increases, consumer credit, expressed as a percentage of individual money incomes, rises. Money incomes, under the view now being discussed, are dependent only on that part of the production which is independent of consumer credit. Therefore, as "that part of production" increases, money incomes will grow in like proportions. Now, if consumer credit always increases by a given unchanged percentage of this growth of money incomes, that is tantamount to saying that con-

⁷⁰ Haberler, *op. cit.*, pp. 133-34.

⁷¹ They are estopped from saying that consumer credit does not increase the cycle's amplitude, for, then, manifestly, consumer credit could have no influence on the cycle other than to affect its timing—a problem already disposed of.

⁶⁸ *Op. cit.*, p. 108.

⁶⁹ James E. Moffatt, "Is Instalment Selling a Boon or a Menace?" *Bankers Magazine*, CXII (February, 1926), 225.

sumer credit is just sufficient to take off the market, together with the cash sales, of course, the production which called the consumer credit into being. Haberler puts it in somewhat different terms by saying that credit is an independent influence on the cycle, assuming complete leakage once again, only if credit sales show wider fluctuations than cash sales.⁷² If the ratio of consumer credit to money incomes rises on the upswing, it must fall proportionately on the downswing. This type of pattern is not impossible, but it is highly improbable. Further, if amplitude is widened, this means that full employment could not have been reached in the absence of the credit, an inference which certainly would not be accepted by these writers if put explicitly to them.

To summarize, for real national income to be unaffected over a complete cycle by consumer-credit movements, it is necessary for consumer-credit movements to be much more restricted than writers holding this view seem to realize. Consumer-credit movements must be completely dependent in timing on the main cycle and yet must increase in importance relative to money incomes (which, are in turn, dependent on production) on the upswing. The weight of statistical evidence would seem to indicate that consumer credit does not behave directly with the cycle, either as to timing or as to amplitude.⁷³ Further, the writers now under discussion must assume that the borrowed funds turn over only once during the debt period, that is, the credit exercises only primary effects on aggregate demand. As Haberler has so clearly shown, even if consumer credit is completely dependent on the cycle both as to timing and as to amplitude, it can still

affect the cycle by producing a credits-outstanding series which will lag. By assumption this means less than complete leakage, that is, secondary and/or tertiary effects are realized.⁷⁴ This aptly disposes of the contention of Ayres that if instalment selling levels off to, say, 5 per cent of everyone's income, it can no longer exert any influence on the cycle.⁷⁵ His practical judgment that the period ending in 1929 fitted this hypothetical leveling-off condition is also open to serious question in the light of the recent statistical studies by Nugent and by the National Bureau of Economic Research.

Nugent's statement that "the significance of consumer credit for cyclical movements lies in the magnitude of its fluctuations and not in the magnitude of its outstanding amount at any given time"⁷⁶ can be accepted as accurate only on the double assumption that the greater the magnitude of the consumer-credit fluctuations, the less will be their dependence on the main cycle and/or the greater will be their tendency to produce secondary and/or tertiary effects on aggregate demand.

Addendum on several minor points.—Danielian holds to the general position that consumer credit cannot increase purchasing power in the long run. He says that the reverse will be true, owing to the "acceleration of exchange, in so

⁷⁴ Haberler, *op. cit.*, p. 134. Does this mean that consumer credit can exercise secondary and/or tertiary effects without first exercising primary ones? Actually the answer is "No." Even when consumer-credit movements are completely dependent on the cycle, they nevertheless exercise primary effects, for the production which called the consumer credit into being could not be taken off the market in its absence. Hence, effective demand is greater than it otherwise would have been by the amount of the credit.

⁷⁵ "Facts and Fallacies on Instalments," *Personal Finance News*, XXIII (April, 1937), 13, 17.

⁷⁶ *Op. cit.*, p. 190.

⁷² *Op. cit.*, pp. 133-34.

⁷³ *Ibid.*, p. 134, and above, chap. ii.

far as this is permitted by [1] elastic demand for the products involved, and [2] by the synchronization between the permeation of outlays by industries (equal to the value of increased production) among the consumers, and the period of liquidation of consumers' credit."⁷⁷ Why the demand must be nearly perfect in elasticity is not at all clear from his mere statement to that effect; hence, the only criticism possible is the charge of lack of clarity. His second condition requires that the "total price of the increased production due to the increase in consumption [be] disbursed to the consumers within the period of the liquidation of their debts."⁷⁸ In the terminology adopted in the present study this would seem to mean that secondary and/or tertiary effects would be realized. If this interpretation is right, Danielian's conclusion is correct. However, it is doubtful that this is what he has in mind, for he concludes that "these conditions [the two requirements] cannot truthfully be predicated of actual facts."⁷⁹ Unfortunately, his analysis of the issue is vague and lacks understanding.⁸⁰

B. RELATIVE DEMAND

Anything which causes consumers to shift their demands among commodities may, especially if the commodities affected bulk large in the economy, exert an originating influence on the cycle.

⁷⁷ *Op. cit.*, pp. 410-11.

⁷⁸ *Ibid.*, p. 405.

⁷⁹ *Ibid.*

⁸⁰ Nugent cites Danielian's argument as evidence in favor of his (Nugent's) position, but he does not attempt to explain what Danielian's argument meant to convey ("Consumer Debt and the Business Cycle," *op. cit.*, pp. 6-7).

The question arises: Is consumer credit a factor of importance in causing relative shifts in demand? Such an influence is possible only if consumer credit, in whole or in part, is associated with certain commodities. This condition is true mainly of instalment-sales credit, which historically has been linked with durable commodities.

The writer has argued elsewhere at length to the effect that the growth of durables over the last half-century is the cause, and the growth of instalment-sales credit the effect, rather than the reverse.⁸¹ This is not to deny that instalment-sales credit has in turn exercised some, if small, influence in diverting purchasing power from "soft" to durable goods.⁸² Instalment-sales credit could exercise further influence on relative demand if only certain durable commodities were obtainable on credit or, once extended to all durable commodities, if credit facilities were withdrawn from some. The chance of either of these possibilities taking place is not great.

It may be concluded that the effect of consumer-credit fluctuations on aggregate demand is much more important than their effect on relative demand. The effect on aggregate demand will probably become of increasing importance in the future as a positive cyclical influence because of the growing importance of anticipated, as compared to unanticipated, credit.

⁸¹ *Op. cit.*, chap. ii.

⁸² Harvey W. Huegy ("An Economic Analysis of Investment Credit" [unpublished Ph.D. dissertation, University of Illinois, 1937], p. 172) seems to go too far in the direction of allowing instalment credit no influence on relative demand.

CHAPTER V

CREDIT CONTROL

STABILITY, THE OBJECTIVE OF CREDIT CONTROL

THE problem of controlling consumer-credit movements in order to offset their natural tendency to exercise a reinforcing influence on cyclical fluctuations has been discussed by only two writers, Rolf Nugent and Professor Haberler. Even though Haberler does not believe consumer-credit movements are important as a causal factor in cyclical fluctuations, he justifies attempts at consumer-credit control on the ground that what is needed is "concerted action in many fields at the same time."¹ Cyclical stability will be promoted by the "maintenance of some degree of stability in the outstanding amount of consumer credit."² The importance of the subject should not be judged by the brevity of the following discussion.

MANIPULATION OF CREDIT TERMS

The major weapon suggested as the means of controlling the amount of consumer credit outstanding is variation in credit terms—relaxing them on the downswing and tightening them on the upswing.³ Discussion in the literature has been limited to instalment credit. Although variation of credit terms is applicable to open-account credit, it may

be inferred that the usual methods of credit control are deemed sufficient in that sphere. Experience may indicate the necessity of extending control of credit terms to all forms of consumer credit. Tightening the credit terms on the upswing would offset the increased demand for consumer credit resulting from rising incomes. Even though more credit was extended each period, the amount of credit outstanding would remain unchanged. This would permit consumer credit to exercise primary effects on aggregate demand, but the multiplier principle would be prevented from operating very effectively. The reverse would take place on the downswing.

Nugent and Haberler both point out that the tightening process would in all probability be more effective than the reverse process. Easier credit terms, if lenders could be persuaded to ease them, on the downswing do not of themselves induce people to borrow more. But, as Haberler points out, extending the maturities of existing debts would by itself prevent a decrease in the credit outstanding and help defeat the deflationary spiral. Easier credit terms on what new credits are made would add to this effect.⁴ The policy, to be successful, must be co-ordinated with monetary control and hence should preferably be administered by the Board of Governors of the Federal Reserve System.

In view of the tremendous administrative difficulties involved in checking up on the credit terms of thousands of re-

¹ Gottfried Haberler, *Consumer Instalment Credit and Economic Fluctuations* (New York: National Bureau of Economic Research, 1942), p. 175.

² Rolf Nugent, *Consumer Credit and Economic Stability* (New York: Russell Sage Foundation, 1939), p. 242.

³ *Ibid.*, pp. 242-43, and Haberler, *op. cit.*, p. 163.

⁴ Haberler, *op. cit.*, p. 172.

tailers and consumer-credit agencies;⁵ in view of the fact that banks finance upward of half of the credits extended by instalment-sales finance companies and a lesser but still substantial percentage of the loans of personal finance companies;⁶ and in view of the techniques already developed by monetary authorities, why not rely solely on existing controls to regulate consumer instalment credit? One writer suggests that present techniques will be just as effective whether instalment credit exists or not.⁷

Manipulation of the discount rate is admittedly of little influence. On the upswing, consumers are not particularly sensitive to small percentage increases in credit price. Further, the interest cost of funds borrowed from banks is not an important "element in the total costs of instalment credit institutions."⁸ Qualitative control or credit rationing would also be difficult, not only on administrative grounds,⁹ but also because there is no way of preventing bank loans to non-consumer borrowers from seeping over into the consumer field.

Open-market operations are not mentioned specifically by Haberler. Nugent undoubtedly includes them in the follow-

ing statement: "As compared with monetary controls available to central banks, changes in instalment terms would exert a more prompt, more direct, and more rapidly measurable check upon demand, and the dangers of inducing a substantial deflation would be minimized."¹⁰ In spite of his elaborate discussion, the precise reason for this does not clearly emerge. Promptness is very important in cyclical matters, but there is no assurance that changes in credit terms could be made effective over wide areas in short order.

Nugent suggests, for example, that changes in credit terms be enforced by requiring bank inspectors to limit portfolios to consumer paper meeting the standards in force at the time of inspection. Evasions could be great, since not all instalment paper reaches the banks. The proportion not reaching the banks is probably much less today than it was before 1937, at which time the Federal Reserve authorities ruled that henceforth instalment paper was eligible for rediscount.¹¹ The importance of the rediscount privilege is indicated by the unsuccessful attempt of instalment finance companies in 1926 to form a rediscount corporation of their own.¹² Returning to the point at issue, to insure prompt and widespread action, all instalment sellers and credit agencies would have to be inspected directly. This is not impossible but yet is not easy.

It is also true that open-market operations may not be effective immediately in all sectors of the economy. Banks are

⁵ Charles O. Hardy, in *Annals of the American Academy of Political and Social Science*, CCXVII (September, 1941), 192.

⁶ John M. Chapman, *Commercial Banks and Consumer Instalment Credit* (New York: National Bureau of Economic Research, 1940), chap. viii. One writer would place the main credit control responsibility on individual banks, since they are in a strategic position to exercise it (James E. Moffatt, "Is Instalment Selling a Boon or a Menace?" *Bankers Magazine*, CXII [February, 1926], 229). Experience has clearly shown that, to be effective, credit control must emanate from a central monetary authority.

⁷ Wilbur C. Plummer, "Social and Economic Consequences of Buying on the Instalment Plan," *Annals of the American Academy of Political and Social Science*, CXXIX (January, 1927), 42.

⁸ Haberler, *op. cit.*, p. 162.

⁹ *Ibid.*

¹⁰ *Op. cit.*, p. 242.

¹¹ For argument that rediscountability is desirable see Milan Ayres, "Instalment Credit in Times of Stress," *American Bankers Association Journal*, XXII (December, 1929), 555-56, 620-22.

¹² "Formation of a Nation Wide Reserve System for Instalment Credits," *Automotive Industries*, LV (December 30, 1926), 1091.

affected unevenly. Some may even retain idle reserves which will permit them for a time to take the opposite course from that which the central bank desires. The most recent addition to the kit of monetary control, the variable reserve ratio, makes this less probable.¹³ Finally, open-market operations may not be wholly effective if, as is somewhat the case, consumer-credit agencies have funds which come from sources outside the banking system. The behavior of "loans for the account of others" in 1928 and 1929 is illustrative of this.

The essential point lies elsewhere than in the relative speeds of action, however. The traditional bank controls operate on the supply side of credit. As Haberler notes, "If demand fluctuates much with the cycle—as it clearly does—there would be cycles in credit even if supply conditions were perfectly stable."¹⁴ The most direct way of stabilizing demand would be to limit the amount of consumer credit each person could borrow to a percentage of his income and to vary this percentage inversely with the cycle. A few writers have suggested such a limitation but for other reasons.¹⁵ The plan would be unworkable from an administrative standpoint. Since consumers are sensitive to down payment and number of payments, the manipulation of credit terms will have a similar effect and enforcement is easier.

Several more or less obvious points may be made. It is in periods such as occurred in the late 1920's, when excess reserves characterized the banking system and hence when open-market operations

did not have a sufficient mopping-up effect, that the manipulation of instalment credit terms has the greatest value as a control weapon. Second, like all credit control methods, control of credit terms provides a better brake than an accelerator.¹⁶ The problem of when to vary credit terms cannot be reduced to simple rules but demands rare practical judgment. In this respect normal, peacetime conditions present a much more difficult problem than those of wartime. During war, tightening of credit terms is generally recognized as desirable on three grounds: to conserve materials, etc., for the defense effort, to prevent inflation, and to defer consumer purchasing power to the postwar period.¹⁷ The current experimentation with Regulation W should provide some indication of the administrative feasibility of controlling credit terms.¹⁸

The manipulation of credit terms will not enable the monetary authority to restrict expansion or contraction, as the case may be, to a given segment of industry. If, for example, buying of durable goods is reduced by tightening credit terms on all instalment credit, the initial effects in those industries will through diffusion become more widespread. The temptation of the instalment industries to evade restrictions by shifting to open-account sales credit may necessitate extension of control to the latter. The chances of this happening do not appear great, however.

Haberler, in a footnote, remarks that credit contraction might be brought about by reducing the price so low that credit agencies could not afford to grant

¹³ Leonard Watkins, "The Variable Reserve Ratio," *Journal of Political Economy*, XLIV (June, 1936), 357-59.

¹⁴ *Op. cit.*, p. 171. See also chap iv of the present study.

¹⁵ See p. 74 below.

¹⁶ Haberler, *op. cit.*, p. 171.

¹⁷ *Ibid.*, p. 166.

¹⁸ The pressure of wartime duties has prevented the writer from making even a tentative evaluation of the problems raised by Regulation W. The present study was completed early in 1942.

credit.¹⁹ This method—he does not advocate it—is the worst possible one that could be conceived, for, as the writer has elsewhere indicated, it would spread illegal lending and seriously endanger the whole consumer-credit business.²⁰

CONSUMER CREDIT AND FISCAL POLICY

Consumer credit may also play a part in fiscal policy. The suggestion has been made many times that government injections of credit to consumers at the bottom of a depression would help in jolting the economic system along an upward path.²¹ The Federal Housing Administration and the Electric Farm and Home Authority of the New Deal are in part experiments along this line. This general subject lies beyond the scope of the present study, which is limited to consumer credit granted by private institutions in response to a spontaneous demand. The problems, if examined, would be found similar in many respects to those raised by a public works program.

LIMITATION OF INSTALMENT CREDIT TO DURABLE COMMODITIES

A study of this kind should contain a few words on another and less important type of suggested credit control. Put in question form, (1) should the grantor of (anticipated) instalment credit look to the commodity or to the borrower for his primary collateral and (2) should (anticipated) instalment credit be limited to commodities which can be used as col-

lateral? In ultimate terms, "instalment credit, like all forms of credit, depends primarily on the credit rating of the individual; the confidence to be reposed in the purchaser is the foundation of the entire transaction whether in instalment selling or in any other kind of selling on credit."²² Yet numerous writers have argued that instalment selling should be limited to commodities which are sufficiently durable to outlast the repayment period.²³ At least one writer would, following British precedent, specifically limit the security to the commodity alone.²⁴

Outside the possible selfish motive which sellers of durable commodities might have in limiting instalment selling to their domain (the writer does not impute this to any of the writers above cited), the only reason which suggests itself for making commodities the main (at the limit, the sole) collateral is that of forcing more conservative credit terms than might otherwise exist. This, in turn, is prompted by three possible reasons. The first is the fear of some sellers that other sellers will use more lenient credit terms as a competitive weapon. That this is a real worry is evidenced by the adoption in 1924 of standard terms on the sale of new and used cars by the National Association of Sales Finance Companies. Balanced against easier credit terms, however, is the greater risk

²² Edwin R. A. Seligman, *Economics of Instalment Selling* (New York: Harper & Bros., 1927), I, 213. See also Harvey W. Huegy, "Instalment Terms," *Credit and Financial Management*, XXXIX (October, 1937), 20.

²³ J. G. Frederick, "Is Instalment Selling Out-reaching Itself?" *Barron's*, VI (April 19, 1926), 9; Herbert F. Boettler, "Significant Economic Developments since the Armistice," *Journal of Accountancy*, XLI (May, 1926), 350; and James Couzens, "The Question of Instalments," *Industrial Digest*, V (October, 1926), 36.

²⁴ Albert Haring, "Instalment Selling of Durable Goods," *Journal of Marketing*, II (April, 1938), 280.

¹⁹ *Op. cit.*, p. 163.

²⁰ Wallace P. Mors, "Rate Regulation in the Field of Consumer Credit," *Journal of Business of the University of Chicago*, Vol. XVI (January and April, 1943).

²¹ See, e.g., Edward Bennett, *Consumer Credit Technique for Restoring Employment* (Madison, Wis.: The Author, 1933).

of loss.²⁵ Limiting the commodities which could be sold on the instalment plan and/or limiting collateral to such commodities appear to be clumsy methods of achieving control over credit terms. The conclusion is valid whether the control is voluntarily imposed on themselves by credit grantors or whether administered by the state.

A second explanation lies in the belief that instalment credit is innately bad but inevitable. The thing to do is to insure its existence on the most conservative grounds possible.²⁶ The analysis of chapter ii has shown this point of view to be unjustified. A third aim is to reduce granting instalment credit on the upswing in the interest of cyclical stability. The manipulation of credit terms provides a superior vehicle for this purpose. It may be concluded that no strong case

can be made for limiting the collateral on instalment credit to a given commodity, nor can any rules profitably be laid down on what commodities shall or shall not be sold the instalment way. This is not to deny the historical association of instalment-sales credit and high-priced, durable commodities. The same conclusions hold for proposals to limit the amount of instalment credit granted any one person to a given percentage of his income.²⁷

In conclusion, the countercyclical manipulation of credit terms represents another means whereby the monetary authorities may tackle the difficult job of controlling credit in the interest of greater cyclical stability. How successfully such a control will work out can be answered only after considerable experiment with it. It does not supplant but rather complements the traditional monetary control devices.

²⁵ David Durand, *Risk Elements in Consumer Instalment Financing* (New York: National Bureau of Economic Research, 1941), pp. 7-8.

²⁶ See Roger Babson, *The Folly of Instalment Buying* (New York: Frederick A. Stokes Co., 1938), chap. viii.

²⁷ J. G. Frederick, "The Answer to the Instalment Selling Situation," *Barron's*, VI (May 10, 1926), 15, and Ralph Manuel, "An Adventure in Small Loans," *Bankers Magazine*, CXXXV (August, 1937), 115.

RATE REGULATION IN THE FIELD OF CONSUMER CREDIT. I

WALLACE MORS¹

THIS study analyzes the problem of rate regulation in the field of consumer credit. Cash and sales credit are discussed separately, since only in the last decade has the historical segregation of the two markets begun to disappear. It has been due to the functional distinction traditionally made between the two, cash credit being thought of as emergency credit, sales credit as incidental to selling. Evidence of this lies in the numerous court rulings that sales credit is exempt from the usury laws.² The present article traces the growing skepticism of competition as a desirable rate regulator in the cash-lending sphere. The one following argues that the usefulness of competition has been underestimated, successively considers the case for it in cash lending and in sales credit granting, and concludes with a brief discussion of reforms necessary to make the field as a whole a more unified, competitive market.

A. REGULATION OF CASH LENDING

SMALL LOAN COMPANIES

The real rise of cash lending dates from the Civil War. Commercial banks, influenced by community aversion toward consumer indebtedness and handicapped by usury laws aimed at preventing borrower exploitation, were unwilling and/or unable to accommodate the demand. Pawnbrokers' collateral-deposit require-

ments were too stringent for most borrowers. A new type of lender, one making salary, chattel, and comaker loans in small amounts, stepped into the breach. Because they violated the usury laws such lenders were termed illegal or, more opprobriously, "loan sharks." Their charges were held to be "out of all proportion to the benefit derived by the borrower."³

Illegal lenders dominated cash lending until about 1920. In the meantime, reform elements, grown vocal after 1900, had by 1910 brought three new types of agencies into being—the remedial loan society, the credit union, and the Morris Plan or industrial bank. Each has operated under a legal maximum rate and has faced virtually similar problems. Lack of space dictates building the discussion mainly around remedial societies and their successors, the personal finance or small loan companies.

Rejection of the usury laws.—Those persons who studied illegal lending became convinced that the need for consumer loans was real.⁴ This contrasted sharply with community condemnation of borrowing, exemplified in the campaigns around 1900 aimed solely at wiping out the loan sharks. Reformers also called the public's attention to the fact that the small size of the average loan and the risks of nonpayment necessitated

³ "To Control Loan Sharks in Illinois," *Charities and the Commons*, XXI (December 12, 1908), 407.

⁴ For documentation in support of generalizations made in this article and the one following see the writer's "Theories of Consumer Credit" (unpublished Ph.D. dissertation, School of Business, University of Chicago, 1942), chap. vii.

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² Raoul Berger, "Usury in Instalment Sales," *Law and Contemporary Problems*, II (April, 1935), 148-72.

rates higher than those permitted by the usury laws.

The early (pre-1920) writers could have sidestepped the problem of determining a desirable rate level by advocating outright repeal of the usury laws. *Laissez faire*, in the light of the conditions then (1900) existing in consumer lending, was correctly rejected.

The usury laws still found in some of the American states are an anachronism. It must, however, not be forgotten that this defense of freedom in borrowing rests on the assumption which underlies all liberty, namely, relative equality of bargaining. Where loans are for immediate consumption rather than for productive purposes the reason of the rule falls away and some degree of protection may be needed for the borrower.⁵

This protection was not required, as has been alleged, to prevent moral usury, defined severally as "taking advantage of the ignorance or necessitous condition of the needy borrower so as to get him into a hard bargain and exact from him unduly high charges,"⁶ or again as using "the necessity of the borrower in order to extract *unconscionable* interest from him."⁷ Such terms as "unduly high charges" and "unconscionable interest" have meaning only with reference to some standard. The traditional one is the satisfaction or benefit realized from the use of credit. Bentham's whole attack on the usury laws revolved around the contention that only the individual can decide what satisfaction he receives from a loan and that therefore he alone is

in a position to judge whether or not its price is exorbitant.

Writers were wrong in using a moral-usury argument to justify reform in the cash-loan field. However, the term, as the campaign gained momentum after 1900, gradually and unconsciously took on a new meaning. As a later summary study puts it, "there can be moral usury only in the absence of a market rate for loans."⁸ It "cannot develop in the large commercial and investment loans of the financial world,"⁹ and thus in the final analysis "true usury is an extortionate rate of charge for a small consumptive loan."¹⁰ Moral usury in this sense is nothing more than "a higher rate of interest than is consistent with a fair rate of profit [return] on the capital employed."¹¹

Charges in excess of those which yield lenders more than a normal profit and result in economic rent should never have been termed moral usury. The approach is sound, however, since it leads to an examination of conditions which prevented effective competition among illegal lenders. This revolves around the differences in conditions underlying producer and consumer lending respectively during the past century. Mr. Ryan correctly criticizes Bentham's failure to see this. He overlooks the point, however, that Bentham assumed competition to be operative and was primarily interested in shattering the illusion of moral usury, using the term now in its correct sense. Mr. Ryan is himself at fault in employing it in two ways without explicitly recognizing the fact.

Effective competition presumes that

⁵ Edwin R. A. Seligman, *Principles of Economics* (New York: Longmans, Green & Co., 1905), pp. 409-10. This edition appeared before the rise of a consumer-credit literature.

⁶ Franklin W. Ryan, *Usury and Usury Laws* (Boston: Houghton Mifflin Co., 1924), p. xi.

⁷ Reginald H. Smith, "Rethinking Usury Laws," *Annals of the American Academy of Political and Social Science*, CXCVI (March, 1938), 189.

⁸ Ryan, *op. cit.*, p. 114.

⁹ *Ibid.*, p. xvii.

¹⁰ *Ibid.*, p. 147.

¹¹ Clarence Hodson, *Money Lenders, License Laws and the Business of Making Small Loans* (New York: Legal Reform Bureau, 1918), chap. iii.

the appearance of extraordinary profits will encourage new producers to come into the business, thereby exerting a downward pull on prices and profits. This in turn presumes that there are always new entrepreneurs willing to enter and that they can get the requisite capital. The unwillingness of the community to permit rates exceeding the usury laws and its condemnation of lenders who insisted on lending at such rates gave the business a stigma. Not only were many lenders driven out of the field by this social pressure, but undoubtedly countless more refrained from coming in. This taint of illegality gave lenders a low social caste: Witness the delight expressed when several were put in jail.¹² Incidentally, the risks of being fined and jailed probably raised the already naturally high costs of lending.

Those who did enter the field were handicapped by difficulties of raising capital.¹³ Loan sharks had to rely mainly on their own funds. This dictated small-volume, high-cost lending. Prejudice has been so strong that even today personal-finance companies, the legal successors to loan sharks, are somewhat handicapped in tapping capital sources. This would lend credence to the statement that the return on investment must be higher than in other lines of business.¹⁴ Remedial societies, due to their philanthropic nature, did not suffer from social stigma but anomalously enough faced a worse handicap—namely, the fact that their

limited-dividend policy was not able to attract capital without concerted campaigns—campaigns which could not be carried on effectively except for short intervals.

Reformers placed the major responsibility for the bad conditions elsewhere, namely, on borrowers' lack of financial integrity and on their desire for secrecy. One calls attention to the "need, ignorance and often shiftlessness"¹⁵ of consumers, another to the need of reforms so that "weakness and inefficiency shall not be exploited."¹⁶

These claims, although of great value as reform propaganda, represent overstatements in a real sense. Without denying that some borrowers were lacking in financial integrity, the conditions existing in 1900 were the worst possible for it to function properly. This was accentuated by the fact that many of the loans were of the unanticipated type, giving borrowers little choice of whether or not to borrow. The reformers in essence admitted this, their desire-for-secrecy factor going much beyond the privacy people normally wish in managing their affairs. It was often pointed out that many employers felt that employees who borrowed were spendthrifts and hence not desirable workers. Only after much spadework has the policy of firing borrowing employees been appreciably lessened throughout American industry. This employer attitude reflected the stigma which the community attached to going into debt. Borrowers were unconsciously affected by it and went to great pains to keep the shame of having to bor-

¹² "Millionaire Loan Sharks behind Bars," *Survey*, XXVII (February 10, 1911), 1728-29.

¹³ Arthur Ham, "Remedial Loans—A Constructive Program," *Proceedings of the Academy of Political Science in the City of New York*, II (January, 1912), 162.

¹⁴ P. L. Alberse, "What Is a Fair Return on an Industrial Loan Investment?" *American Industrial Licensed Lenders Association Yearbook*, December, 1920, p. 46.

¹⁵ Roswell McCrea in Clarence Wassam, *The Salary Loan Business in New York City* (New York: Charities Publications Committee, 1908), p. vii.

¹⁶ Frank Tucker, "The Social Need for Remedial Loan Associations," *Proceedings of the National Federation of Remedial Loan Associations*, 1909, p. 26.

row from becoming known even to friends and relatives. One writer asserted that they were often willing to pay high rates to prevent the repossession of their household equipment, since that is a "dead give away" to outsiders.¹⁷

Persons who feel that they are breaking traditions are rarely bold in their actions. In cash lending, hesitancy took the form of reluctance to shop around among lenders. Social stigma operated to make ineffective what shopping was done. Lenders could not afford to quote prices openly, nor could they be forthright in their advertising for fear of running afoul of the usury laws. To this must be added the lower tone of lender ethics arising from the pre-emption of the field by businessmen with "hard skins." In reading the literature one develops after a time the feeling that the unscrupulousness of loan sharks has been overdrawn. They were to a large extent the victims of circumstances not of their own making. The generally low tone of the whole business of 1910 is exemplified in the observation that illegal lenders were often swindled by borrowers and, worse, that many persons regarded this as virtuous behavior.¹⁸

The inadvisability in the early 1900's of adopting a laissez faire position is apparent. Given the community attitude and the loan-shark tradition, conditions would scarcely have improved by themselves. Partial proof of this is afforded by the experience in Massachusetts and Connecticut, where all usury laws were abolished for a time after 1867 and 1869, respectively. The situation there was as bad as in the states with laws. The

speech of Richard H. Dana, Jr., delivered in 1867 in favor of the repeal of the Massachusetts usury law, is often quoted in the consumer-credit literature, sometimes to bolster a laissez faire argument and sometimes to show how far off he was from reality. It seems clear, however, that he had only productive loans in mind in taking his stand against usury laws. He specifically says, "it is not the poor mechanic that is the borrower. It is mostly enterprise that borrows and capital borrowing more capital."¹⁹ The community acceptance, even encouragement, of producer lending provided conditions which made workable a policy of laissez faire in that sphere.

Mr. Ryan attempts to justify this contrast in policy by transcending historical considerations. He notes that the interest charge covers not only pure interest but also the cost of making and collecting the loan and the risk of nonpayment. The pure-interest rate is set by the demand and supply forces of the market, and therefore a law to regulate it would be useless. The other elements are not, however, similarly governed. He states that pure interest comprises the bulk of the charge on productive loans, whereas it is only a small part of the charge on consumer loans; he concludes that market forces set the rate on the former but not on the latter. Therefore, in the absence of a market rate some other regulatory force is necessary to protect customers.

To substantiate this conclusion it is incumbent on him to show why the other elements in the consumer-loan charge are not susceptible to market forces. The re-

¹⁷ Edwin Lewis Theiss, "Loan Slaves and Their Emancipation," *Independent*, LXV (November 5, 1908), 1054.

¹⁸ Charles Rogers, "American Unthrift," *Atlantic Monthly*, CVII (May, 1911), 693-701.

¹⁹ "Speech on Repeal of the Usury Laws," *Usury Laws* (New York: Society for Political Education, 1884), p. 56. See also George Pratt, *Speech in the Connecticut House of Representatives on the Bill Providing for the Repeal of the Usury Law* (Hartford: Lockwood & Brainard, 1869).

mark that some productive loans would seem to necessitate similar treatment is offered in light of the fact that wide variations exist at any one time in their rates of return. These variations cannot be accounted for in terms of differences in the pure-interest rate, since, as Mr. Ryan himself says, it does not vary except through time. He argues that whereas the pure-interest rate extends to every loan simultaneously the other elements in the loan charge are individual to each loan. Their "costs are determined by the particular sets of circumstances" peculiar to each.²⁰ The conclusion that demand and supply forces fail in setting them is a *non sequitur*.

The clue to his real position is found in the statement that "the rate is not determined at the margin by the free interplay of economic forces, but is a resultant of the unequal bargaining positions of the parties to the loan . . . where the borrower is always at a disadvantage."²¹ This is merely another example of the emphasis the literature has placed on the historical conditions handicapping consumer borrowers in getting loans at reasonable rates. Mr. Ryan's analysis therefore in reality follows the pattern of his predecessors. As stressed in this study, the basic factor is the social stigma which traditionally has surrounded consumer lending.

Encouragement of reforms specially adapted to consumer lending.—Under the leadership of the Russell Sage Foundation and its major spokesman, Mr. Ham, reformers bent their efforts toward securing the passage of legislation specially adapted to consumer lending—constructive legislation, so called. Among other things it licenses lenders and sets a maximum rate in conformity with the community's religiously held belief in it, but

at a level high enough to permit consumer lenders to operate profitably within the law.

The usual justification of an increase in the rate level was on cost grounds. Mr. Ryan is needlessly overinvolved on the point. He indorses constructive legislation and at the same time says, with Bentham, that a statutory maximum is wrong in principle. Then comes the dilemma: "If we hold that a general statutory maximum for loan charges is wrong in principle, how can we hold that a special statutory maximum is right in principle?"²² In resolving it he starts with the remark that a general statutory maximum falsely assumes all loans to be similar in cost. This is also true of a special statutory maximum, but he claims the danger is less because it isolates "a particular class of loans." The allegation that a general statutory maximum sets up a "rigid false definition of usury which relegates the true definition of usury to the background," Mr. Ryan says, does not apply to a special statutory maximum because, being based on scientific study, it attempts to equate legal and moral usury.²³ As already noted, his work suffers from his implicit use of the term "moral usury" in two senses.

Pursuing his analysis to its logical conclusion would seem to indicate that statutory maximums are not wrong in principle if they try to set legally rates which do not permit moral usury. That he subscribes to this view is indicated by the statement that "legislators hesitate to repeal the old usury laws because the theory of the laws is correct even if a general statutory maximum is wrong in principle."²⁴ He reconciles this legal theory of a usury law, as he calls it, with the laissez faire economic theory against regulation by the statement that "the [le-

²⁰ *Op. cit.*, pp. 8-9, 145.

²¹ *Ibid.*

²² *Ibid.*, p. 143.

²³ *Ibid.*

²⁴ *Ibid.*, p. 175.

gal?] theory of a usury law was never expressed as an attempt to control the market rate of interest. It is simply using the police power of a state to remedy a bad situation where two parties are in unequal bargaining positions."²⁵

How the usury laws can be correct in theory and wrong in principle is not clear. He cannot mean that they are valid when the rates are set so high that all loans can be made profitably under them, since such rates would be the same as no rates. It is likely he means something else—what, the writer does not venture to guess. His reference to the market rate of interest goes back to his argument that market forces determine it but not the other elements which make up the consumer-loan charge. This contention has already been denied him. His elaborate and faulty analytical apparatus seems to come down to the fact that, given competitive conditions, usury laws are economically unnecessary; but where such is not the case a statutory maximum, preferably adapted to a particular (cost) segment of the loan field, is desirable on social grounds. Moral usury introduces an unnecessary complication and is better omitted.

Reformers deemed legislation alone insufficient. It "can contribute to a solution of the problem if for repressive measures it will substitute discretionary regulation based on contemporaneous information; but the immediate remedy must be sought in competition."²⁶ The type of competition envisaged lends striking testimony to the thesis that social stigma was a primary cause of the bad conditions then existent in consumer lending. It consisted of two nonbusiness types of agency—semiphilanthropic or remedial

loan societies and co-operatives or credit unions. Their welfare nature was relied upon to break the loan-shark tradition and, since they were not considered a permanent solution to the problem of adequately meeting the consumer-loan demand,²⁷ to pave the way for the return of business lenders, now under legal sanction.

By 1920 success had been sufficient to convince a growing number of writers of the soundness of the reform ideas.²⁸ Many business lenders had reformed and were operating under the Uniform Small Loan Law drawn up in 1916 under the direction of the Russell Sage Foundation and passed by a number of states. Lenders refusing to comply have by extension been called loan sharks. Remedial societies had served their purpose, and only a few remained in existence.²⁹ Credit unions, although continuing to grow, have never been of great quantitative importance. Publicity proved to be a helpful adjunct in promoting the whole reform campaign.

The problems of competition within a specially constructed flat-maximum-rate structure are best brought out by considering the history of personal finance companies since 1920. The maximum to be

²⁷ Ham, *op. cit.*, pp. 161-69. This further bears out the stigma thesis of the text.

²⁸ See, for example, Reginald Heber Smith, *The Facts about the Small Loan Business and the Scientific Rate of Fair Charges* (New York: Legal Reform Bureau, 1922), pp. 1-19. In this tract he quotes copiously from articles written by public officials, jurists, newspaper editors, and professors, all of them justifying competition within a constructive legislative framework.

²⁹ For a detailed account of their history see Louis Robinson and Rolf Nugent, *Regulation of the Small Loan Business* (New York: Russell Sage Foundation, 1935), chaps. iv-vii. Paradoxically, they refused to ratify the Uniform Law until 1919. To a natural suspicion of business lenders was added the reluctance to welcome a competitor. The remedial societies and the Russell Sage Foundation were not in complete harmony between 1916 and 1919.

²⁵ *Ibid.*, p. 148.

²⁶ Roswell McCrea, "Salary and Chattel Loans," *Survey*, XXII (August 14, 1909), 680.

selected raises a question, since what is a profitable rate varies with loan size, grade of borrower, and technical efficiency of lenders, including in the latter the external conditions in which they operate. Early writers were mainly concerned with the first variable and concentrated on loans under three hundred dollars, "an arbitrary choice that appeared to mark a convenient separation of borrowers who have bankable collateral from those who normally do not."³⁰ As more data became available the maximum gradually was moved up from 2 per cent a month to the $3\frac{1}{2}$ per cent figure which in 1916 was written into the Uniform Small Loan Law. Remedial societies had prepared the way for this high a rate.

It was hoped that the new maximum rate would attract legitimate capital into the field. Early writers, as above noted, were aware that costs varied with loan size and grade of borrower. They did not say so outright but probably knew that the statute rate delineated the smallest loan and the least desirable borrower that lenders could accommodate profitably. This may be called the selective principle.³¹ Competition to be effective presumably should do two things: First, it should set differential rates, i.e., produce a schedule of rates which fall with increased loan size and/or improvement of borrower risk. Second, it should lower aggregate rates, i.e., the rates on all loans, as lenders become more efficient either because of internal or because of external improvements in lending. As late as 1930 the general opinion seems to

have been that competition among an unrestricted number of lenders would accomplish both objectives more or less satisfactorily.

Unrestricted competition and aggregate rate reductions.—By 1924 small loan laws had been in force in enough states for a sufficiently long time to give some inkling of how unrestricted competition would work out. In that year one writer called attention to the fact that "in the matter of interest charges the ordinary laws of competition, curiously enough, do not seem to operate . . . between industrial lenders. Their rates are adjusted to meet the highest fixed charges allowed by law and not, evidently, by any consideration of underbidding their commercial rivals."³² Beyond laying the cause to lenders' practice of overextending loans at the expense of safety, he developed the argument no further.

It has long been known that the cost of making loans tends to be inversely proportional to a lender's loan volume.³³ Building on this, Professor Fisher points out that, "if business units are to be operated on . . . a small scale, it is naturally necessary to load the interest with a premium sufficient to take care of the overhead in each case."³⁴ He claims that the Uniform Small Loan Law has permitted too many to enter the field. The consequences have been increased advertising and more lenient credit terms in an effort to maintain a given (small) loan volume. His conclusion is: "If the intent of the law is to protect the worthy borrower, it is difficult to see wherein it

³⁰ M. R. Neifeld, *The Personal Finance Business* (New York: Harper & Bros., 1933), p. 300. Credit-union legislation usually has a thousand-dollar maximum.

³¹ Rolf Nugent, "The Changing Philosophy of Small Loan Legislation," *Annals, CXCVI* (March, 1938), 210.

³² Charles F. Bigelow, "Competition with Commercial Lenders," *Bulletin of the N.F.R.L.A.*, September, 1924, p. 9.

³³ Arthur Ham, "Loan Sharks Triumph in Washington," *Outlook, CIV* (August 2, 1913), 734.

³⁴ Clyde Olin Fisher, "Small Loans Problem," *American Economic Review, XIX* (December, 1929), 191.

becomes necessary to grant a license to every group which wishes to invade the small loan field in the hope of picking up a few dollars."³⁵ He tentatively advocates that population be the standard for determining the number of agencies.

Given perfectly competitive conditions, an optimum-size firm will automatically result. Only if costs were constant could the number of firms be indefinite. Given short-run rising costs, that number of firms would stay in business which could reach the optimum size under the maximum rate level then in effect. The others would drop out. Unless the rate were set very low there would probably be a sufficient number left to make possible the competition envisaged by early writers. If the assumption of perfect competition is dropped (and with later writers it is assumed that imperfect competition exists), then the above argument must be modified. A maximum rate would no longer set even broad limits to the number of lenders, since those with less than optimum capacity would exist by charging rates higher than those of optimum-size lenders and still not be driven from business because of imperfections in the market.

The major defect of Professor Fisher's analysis is that he merely asserts that a given trend has taken place. One writer attempts to answer by an appeal to experience, i.e., the case of the Household Finance Corporation's rate reduction in 1929 on loans over one hundred dollars. This grew partly out of its ability to float securities through regular investment channels, open for the first time to a small loan company, thereby lowering the cost of acquiring capital. Tacitly admitting that this voluntary action may take some time, he nevertheless believes

that "it is far better to wait for this than to reduce the rate by legislative action to the point where only meager and inadequate profits can be obtained and thereby to stop the flow of capital into an important field which needs it."³⁶

This type of argument failed to satisfy critics, and a growing number have since 1929 repeated Professor Fisher's proposal. The Russell Sage Foundation revised the Uniform Small Loan Law in 1932 by introducing a necessity-and-convenience clause. By it the state supervisory body may reject new licenses if it feels that there are already sufficient loan facilities in the area.³⁷ The criteria to be used in making such a decision are not specified in the law. It is essential to distinguish sharply another innovation of the 1932 revision, namely, the requirement that lenders employ a minimum capital of \$25,000 per loan office. The latter is justified on cost grounds, studies having shown that too small a loan volume makes for unnecessarily high costs. As long as the minimum is within reason it does not operate to limit lenders to the number that some state official thinks desirable in the public interest. The lat-

³⁶ Louis Robinson, "Small Loans Problem," *American Economic Review*, XIX (December, 1929), 639. For a similar conclusion see Citizens Research Committee, "Findings and Conclusions," in "Wisconsin Study of the Social Effects of the Small Loan Law" (1929), p. 6. (Mimeographed.)

³⁷ Robinson and Nugent (*op. cit.*, pp. 119-20) mention the 1932 revision of the uniform law without comment. Then, on page 244, they say that the small-loan business is essentially competitive. In view of Mr. Robinson's previous stand against limiting the number of agencies, it is difficult to tell whether or not he has reversed himself. The dilemma is made worse by the fact that the book is published by the Russell Sage Foundation. On top of that Mr. Nugent, the other author, in 1935, if not before, favored agency restriction on the ground that it would implement, not decrease, competition (see *Sixth Draft of the Uniform Small Loan Law* [New York: Russell Sage Foundation, 1935], pp. 1 ff.).

³⁵ *Ibid.*

ter, as will be argued in the next article, is distinctly dangerous.

One writer explains the purported ineffectiveness of unrestricted competition as follows:

As a competitive move by one lender against the field, it [a rate reduction on his part] degenerates into a predatory expedition in which the aggressive lenders prey on the accounts that deal with the other lenders. There is a shift of borrowers among the lenders, but no material influx of borrowers from outside who are attracted by a cheaper rate. And if the other operators are forced to meet the reduced rate, the emigration of borrowers between offices stops, and the lenders find themselves with no increased demand for loans from new borrowers to compensate in volume for loss in income.³⁸

Actually this proves the reverse. The fewer the number of agencies the more will any one take into account the actions of others in response to a given price reduction by him. Only with a large number of agencies will they act completely independently of one another and so maximize the effectiveness of price competition. It should be particularly effective in cash lending, viz.:

Although price is but one of the criteria by which the borrower selects a lender, the lender who charges less and who advertises his lower charges will unquestionably attract customers as readily as the merchant who advertises lower prices for food or clothing—and *more so because there is no difference of quality*.³⁹

Furthermore, Mr. Neifeld does not take account of the fact that price reductions will drive some lenders out of business unless he assumes that they all have similar cost conditions. The relative smallness of fixed costs should hasten the process. Of added curiosity is the statement that his position is based on the practical, i.e., high-cost, conditions governing up to the time (1933) that he

wrote his book. Conceivably the art of credit extension may in the future be so perfected as to lower appreciably the cost of making loans. More important is the possibility of new and cheaper avenues of raising capital. These cost-reducing developments, when and if they take place,

will make the demand for small loans elastic. Large new classes of borrowers will see in the personal finance companies a source of immediate, economical credit; and the appearance of these classes of borrowers, not now served, will open for personal finance the possibility of vast expansion.⁴⁰

Why should cost reductions in the future do what he claims they have failed to do in the past? On this insecure foundation he comes to the conclusion that, "instead of regarding the necessity and convenience clause as a bastard interloper, it would be more farsighted to embrace it as a legitimate means of preserving what has hitherto been won in the way of public esteem."⁴¹

Using the recent development of the doctrines of imperfect competition, Professor Yntema points out that, due to differentiation of loan services, limitation of seller-buyer contacts, and borrower ignorance of the service, there are stratifications in the loan market.⁴² He goes on to say that, given an imperfect market, profits of lenders will be high unless rates are progressively reduced by law or many firms enter the field to keep the average loan volume small and operating costs high. (This will be particularly the case if marginal advertising cost

³⁸ *Op. cit.*, p. 443.

⁴¹ *Ibid.*, p. 447. In his latest book, *Personal Finance Comes of Age*, pp. 86-88, Mr. Neifeld shifts over, with due credit, to the somewhat different type of analysis developed by Professor Yntema.

⁴² Theodore O. Yntema, "Market for Consumer Credit: A Case in Imperfect Competition," *Annals, CXCVI* (March, 1938), 79-85.

³⁸ Neifeld, *op. cit.*, p. 442.

³⁹ Robinson and Nugent, *op. cit.*, p. 244. (Italics are mine.)

risers rapidly.) The first reservation is not necessarily true. Much depends on the type of risks chosen and the size of loans made by lenders. Studies exist which show that profits do not vary substantially in states having different maximum rates.⁴³ As to the second, free entry into the business is the best safeguard against monopolistic exploitation and the return of illegal lenders.

Professor Yntema comes to the tentative policy conclusion that it may be necessary to set maximum rates so low that only large, efficient lenders can operate profitably and that it may also be necessary to limit the number of lenders by a licensing system. No margin would exist for advertising costs. Then price competition might be promoted by the government or voluntarily, but he feels that one cannot be too sanguine even then, since differentiation of lenders will still cause some rigidities.⁴⁴ It may be presumed that this conclusion is not peculiar to cash lending, for he states (in a footnote, it is true) that most retail markets are imperfectly competitive.⁴⁵

In any event this carries to its logical conclusion the skepticism toward competition in consumer cash lending. Early writers repudiated laissez faire and advocated competition among an unrestricted number of lenders operating under a flat-maximum-rate law. Those writing since 1920 have in large part repudiated unrestricted competition in favor of competition among a limited number of lenders.⁴⁶ And now Professor Yntema

suggests that even here one cannot be too sanguine. If this is correct the major (whole?) reliance in setting rates must rest with the state. The writer believes the usefulness of competition has been understated. Before elaborating on this statement, one other aspect of competition within a legislative framework requires analysis.

Unrestricted competition and the adjustment of differential rates.—This other aspect concerns the selective principle and has two strands. The first is pointed to in an early editorial comment to the effect that a proposed bill allowing a charge of 4 per cent a month would eliminate the worthless class of borrowers and permit lower rates to worthy ones, since they would not have to support the bad credit risks.⁴⁷ A lender somewhat later called attention to the other strand when he noted that remedial societies lost money on the smaller loans (those of, say, twenty-five dollars or less), since they cost more to make than allowed by the legal maximum. He raised the question, essentially social in nature, of whether these loans should be made in order to prevent applicants from borrowing from illegal lenders at higher than legal rates.⁴⁸ The same idea is reflected in a later statement that the small-loan law "does not adequately provide for the smaller loans and . . . the rate is too high on the large loans."⁴⁹

It is doubtful if the early writers

⁴³ Robinson and Nugent, *op. cit.*, chap. xi.

⁴⁴ *Op. cit.*, p. 84.

⁴⁵ *Ibid.*, p. 82.

⁴⁶ Space permitting, it would be possible to trace a growing demand by bankers for limitation of the number of banks making consumer loans. See, for example, Eugene Schleh, "New Credit Field for Banks" (unpublished dissertation, Graduate School of American Bankers Association, 1938), p. 30.

⁴⁷ "To Control Loan Sharks in Illinois," *Charities and the Commons*, XXI (December 12, 1908), 408. See also W. P. Woll, "Do Conditions in the South Warrant a Higher Rate than the Uniform Rate?" *Bulletin of the American Association of Personal Finance Companies*, V (November, 1919), 56-57.

⁴⁸ E. E. Stroup, "Pawnbroking Rates," *Bulletin of the N.F.R.L.A.*, II (August, 1913), 41.

⁴⁹ Walter S. Hilborn, "The Year's Progress and the Uniform Law," *Yearbook of the American Licensed Lenders Association*, November, 1919, p. 29.

grasped the full implications of the selective principle. They were primarily interested in eradicating the loan-shark tradition and discussed it usually by way of an *obiter dictum*. They seem to have believed that this problem, like that of rate reduction, would automatically be solved through unrestricted competition. This is substantiated by their explicit realization that a legislative rate eliminates all borrowers below a given quality level and all loans under a certain minimum size and by their implicit reliance upon competition to supply the demand of all grades of borrowers above the minimum risk and/or for all sizes of loans over the minimum size. No direct references can be cited here. It is claimed by two later writers that "Messrs. Ham and Hilborn [two of the early reformers] conceded that small loans could not be made for less than this rate [$3\frac{1}{2}$ per cent a month] and they believed that competition for the larger and less hazardous loans would result in lower rates in those classes of loans where profits might otherwise be excessive."⁵⁰

After 1928 an increasing number of writers charged that competition was not adjusting differential rates. Although not the first to note the problem, a round-table discussion in 1931 before the American Economic Association considered it in detail. One speaker said that the argument that a $3\frac{1}{2}$ per cent a month flat maximum rate is necessary to attract capital ignores the well-known fact that "the rate of interest determines what customers will be accepted, i.e., the marginal borrower. The higher the rate the more reckless the lender may be in granting loans."⁵¹ He added: "It is not possible to ascertain what rate of interest will

result in a fair return on capital."⁵² This is indeed a far cry from the arguments of early writers to the effect that the essential need in the small-loan business was a rate which would permit a fair return on investment. That he is skeptical of the ability of competition to lower rates on larger and/or less risky loans below the legislative maximum is evidenced by the conclusion that "sound public policy requires that interest rates be graduated with the size of the loan."⁵³

In the main this proposal was not well received by the other speakers, although they offered no particularly cogent arguments against it. One who was mildly agreeable added the word of caution that rate graduation "is not so easy since no legislature would permit a rate high enough on the very small loans to take care of the cost of making them."⁵⁴ The assertion that "credit extension is not affected in any manner whatsoever by the rate"⁵⁵ may be dismissed as superficial and unfounded.

There are real difficulties with a legislatively set graduated rate structure. "Theoretically, every loan transaction should stand squarely on its own. . . . But strict application of the principle would lead to impractical rates on the smaller loans."⁵⁶ For example, 20 per cent a month might be necessary on loans of ten dollars or less—a rate too high in all probability to get through a legislative body or to win public approval. A flat rate, while not scientifically accurate, permits lenders to accommodate all types of loans by the "shifting of

⁵² *Ibid.*

⁵³ *Ibid.*, p. 14.

⁵⁴ Burr Blackburn, "Small Loan Business," *American Economic Review*, Suppl. XXI (1931), p. 26.

⁵⁵ R. W. Pitman, "Small Loan Business," *American Economic Review*, Suppl. XXI (1931), p. 17.

⁵⁶ Neifeld, *op. cit.*, pp. 291-92.

⁵⁰ Robinson and Nugent, *op. cit.*, p. 115.

⁵¹ Clyde Olin Fisher, "Small Loan Business," *American Economic Review*, Suppl. XXI (1931), p. 13.

part of the cost from the smaller loans to the larger borrowers."⁵⁷ In other words, under a flat rate the charge on all loans is virtually the same. Borrowers who are high-grade risks and/or borrow large sums pay more than required by strict costing.

Mr. Neifeld defends this by saying: "It is franking a compromise. It sacrifices scientific accuracy to desirable social consequences and practical operating expediency."⁵⁸ Thus one answer to a graduated rate structure is that it would destroy the major purpose of legislation—the accommodation of all types of borrowers and all sizes of loans. He fails to draw a further implication of this stand for competition, namely, that its objective should be not to reduce rates below the legislative maximum but to insure that lenders provide a well-rounded loan service. Any substantial lowering of rates all around would be desirable, but any growing differentials in rates among different types and sizes of loans in favor of the more profitable classes would be *prima facie* evidence that lenders were becoming restrictive in their loan policy. The absence of reductions in aggregate rates would not, however, constitute proof that the subsidization policy was being carried out, since lenders might restrict their loan service and still fail to make extraordinary profits. This could happen if they incurred heavy advertising or other costs or had poor lending techniques.

The analysis of Messrs. Robinson and Nugent is interesting because it attempts to harmonize a graduated rate structure, the subsidization policy, and competition. They reiterate the current opinion that there is no such thing as a "scien-

tifically accurate maximum rate." They add:

The question of the maximum rate is practical rather than ethical. In its final analysis it resolves itself into the question, What is the lowest rate that will attract private capital to the business of making the kind of loans which the regulatory act contemplates?⁵⁹

The latter excludes loans "to borrowers to whom an interest rate commensurate with the cost and risk of loss involved in making the loan would result in economic peonage."⁶⁰ After noting the experiences of states with different maximums, they come to the tentative conclusion that the range of rates which attracts capital for the purpose of lending in sums of three hundred dollars or less starts at 2 per cent a month. Any rates above this figure permit lenders to accommodate poorer credit risks and/or smaller loans. They conclude: "For the present, at least, this theory suggests that the determination of the most satisfactory rate is a social rather than an accounting problem."⁶¹ How it can be a social and yet not an ethical problem they do not explain.

One of the difficulties of competition within a flat-rate maximum lies in "an increasing tendency of licensees to avoid smaller loans and frequently to lend larger sums than the borrower is able to repay without hardship."⁶² It should be noted that they are careful not to fall into the trap of claiming the failure of competition to provide a well-rounded loan service on the grounds that differential rates have not appeared. They go behind that directly to the type of loans they assert are being made. Their conclusion is: "In order to offset this tendency and to apportion charges more

⁵⁷ *Ibid.*, p. 298.

⁵⁸ *Ibid.*, pp. 298-99.

⁵⁹ *Op. cit.*, pp. 243-44.

⁶⁰ *Ibid.*, p. 245.

⁶¹ *Ibid.*, p. 265.

⁶² *Ibid.*, p. 267.

equitably among borrowers of large and small sums, it would seem proper to fix maximum rates on a sliding scale varying with the size of the loan."⁶³ However, they would compromise to the extent that "the scale of charges on larger loans should be designed to make these loans less attractive to the lender, and to relieve the interest burden of borrowers of larger sums, but these loans should probably continue to bear somewhat more than their proportionate share of overhead expenses."⁶⁴ Paradoxically, they believe that under sliding rates "competitive forces should be relied upon to compel reductions in rates for the more profitable loans and in communities where lending costs are low."⁶⁵

In 1935 the Russell Sage Foundation was sufficiently impressed with the above

considerations to insert a graduated rate structure in the sixth draft of the Uniform Small Loan Law. Its long leadership in the small-loan reform movement makes this an event of importance. The Foundation believes that the flat rate, by causing lenders to concentrate on the larger loans, has permitted illegal lenders to creep back into the business of making the smaller ones. If it is true that too high a rate breeds loan sharks (that too low a one does, has already been sufficiently brought out), then competition must be judged incompetent in providing a well-rounded loan service. Soon a three-rate structure will be needed and finally a multiple one. Since the latter could be set up only by an administrative body, whole reliance on rate-setting would have passed to the state.

⁶³ *Ibid.*

⁶⁴ *Ibid.*, p. 269.

⁶⁵ *Ibid.*

[To be continued]

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RATE REGULATION IN THE FIELD OF CONSUMER CREDIT. II*

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THE previous article traced the growing skepticism with which writers have regarded competition as an effective regulative force in the small-loan field. What follows is an examination of the merits of such a position.

The negative case for competition within a flat-rate structure.—Before being willing to abandon competition it is necessary not only to ascertain its merits but to weigh alternatives. Because administrative rate control represents the other extreme from competition, and because several states are already experimenting in this direction, it is the alternative considered in the discussion which follows. The merits of a graduated (two) rate structure, legislatively set, are touched upon later. The writer is willing to admit at the outset that competition has not operated with theoretical smoothness in lowering aggregate rates and in adjusting differential rates. Further, that should not be expected, since all actual markets contain imperfections. Only if the latter are very great must competition be supplanted, and what follows shows that there is little evidence that cash lending is unduly peculiar in this respect.

The cost (price) of making loans depends on three variables—quality of borrower, loan size, and lender efficiency. Since there is no way of dealing directly with differences in lenders' personal abilities, lender efficiency may be considered largely a function of the size of the loan office. Of the three variables the first is

the least subject to measurement and therefore is difficult to deal with administratively. No efforts have been made to do so. "Few people have been bold enough to suggest that state or municipal governments should undertake to make . . . small necessitous loans, the collectability of which depends in larger measure on the judgment of the lender in selecting his borrowers."⁶⁶ The same conclusion holds a fortiori of any attempt by the state to control the selection of risks by private lenders; the separation of authority and financial responsibility would bring about an impossible situation. The conclusion is inescapable that "in the final analysis, competition must be relied upon to determine the credit standards which will be applied under any rate structure."⁶⁷

Probably because of its objectivity the size-of-loan factor has received greater legislative attention. It is not possible to say that all loans of the same size have the same cost unless, as is rarely true, all the borrowers in question are equal in risk. (Differences in size of loan offices are abstracted from here.) A loan may be thought of as a combination of a given size and a given risk grade. A flat maximum rate designates an infinite number of these combinations as marginal, i.e., as loans which it is only just profitable to make. All combinations in which either or both parts are better than marginal are more profitable at the maximum rate.

⁶⁶ Robinson and Nugent, *Regulation of the Small Loan Business*, p. 243.

⁶⁷ Nugent, "Changing Philosophy of Small Loan Legislation," p. 210.

* The first part of this article appeared in the January, 1943, issue of this *Journal*. The numbering of the footnotes is continuous.

What will be the result if an administrative body has the power to vary maximums by any size gradations it chooses?⁶⁸ For each loan size the rate chosen sets the minimum grade risk which can be accommodated. If many borrowers cannot qualify, lenders will turn them down or in some cases perhaps urge them to borrow smaller sums. The latter would probably meet with community approval since there is a widespread belief that overlending exists. More serious still, if many borrowers were turned down, this would encourage a return of illegal lenders.

This danger is the greatest which consumer lending faces. The community has been slowly educated to a 3 per cent a month maximum rate. It should now be educated to believe in such a maximum with religious-like fervor. Anything which destroys this will revive the ever dormant conviction that 6 per cent a year is sufficient. The payment by some borrowers of a rate slightly higher than that required by strict costing is definitely a lesser evil than requiring many more borrowers to pay still higher rates under repressive lending conditions.

Another real difficulty of administrative discretion is the impossibility of knowing what maximum to set for each loan size, even granted that risks can be graded. Anyone even superficially acquainted with economics knows that marginal and average costs vary among firms (to introduce differences in size of loan offices into the analysis) and within the same firm at different levels of output (loan volume). Even granted that full cost data were available, there would be none but arbitrary rules to guide the administrator. As the number of loan clas-

sifications increases, the limits of tolerance would become more narrow, i.e., the range of risks that lenders could accommodate would decrease. Shrinkage in loan volume would in turn aggravate matters. The absence of cost data at the present time, and probably in the indefinite future, provides fuel for added skepticism. The uncertainty that given rates would remain in force might discourage capital from entering the field.

A flat maximum rate meets these difficulties by giving lenders sufficient leeway in which to operate and by giving them some assurance of an adequate return on capital. Statements that there is no one rate which will attract capital are true but pedantic. Experience has shown that at maximums below 2 per cent lenders refuse to remain in the field. It is impossible for all of them to concentrate solely on high-grade, large-size loans. Therefore an extra margin of 1 per cent a month is necessary in the interest of a better-rounded loan service. The alternative is a return of illegal lending.

There has been frequent criticism that under a flat-rate structure lenders fail to make less desirable loans. What studies are available show that a not inconsiderable proportion of loans—one-sixth to one-fifth—range below fifty dollars in amount. It is true that one company, at least for a time, concentrated on larger loans, but this is exceptional. If widely practiced, it would weaken the effectiveness of a subsidization policy. Competition cannot very well lower aggregate rates and adjust differential rates at the same time—but neither can administrative rate-setting for that matter.

Although lenders cannot be forced to adopt a subsidization policy, they probably have done so to some extent because it is impossible in practice for them to adjust rates by small gradations. Fur-

⁶⁸ For praise of such a method and for a suggestion of some one hundred and forty loan classes see Ryan, *Usury and Usury Laws*, pp. 153-54.

ther, there is reason why they should not attempt the latter. Lenders undoubtedly take all the more desirable loans that they can get. The less desirable ones can then be accommodated as long as their marginal cost is less than (at the limit equal to) the revenue received from them, even though the latter is less than their average cost.⁶⁹ If the point is reached at which marginal cost exceeds average cost the proposition is a fortiori true. With administrative rate-setting it is likely that the subsidization policy would have to give ground, since lenders would have to work within narrower rate limits whether they so wished or not. It is difficult, given free entry into the business, to see the validity of the Russell Sage Foundation's point that a two-step rate structure (and by extension a multiple one) forces lenders to make more of the smaller loans than a one-rate structure.

The subsidization policy is desirable because it gives the surest guaranty against the greatest danger that haunts cash lending—the return of illegal lending conditions with all that that implies. Even with competition under a flat-rate maximum the policy cannot be stretched too far—a fact which has given rise to needless misunderstanding. It has been estimated that the cost of loans of ten dollars or less ranges up to 300 per cent a year. The community, it is true, has not squarely confronted the problem; but, given present prejudices, it would be unwise to try to get legal sanction for such rates. Since most lenders cannot afford to subsidize them, the best policy is to allow the demand to go unsatisfied. Why endanger the whole lending struc-

ture in the interests of the very lowest fringe of borrowers? Recourse to pawn-brokers, credit unions, or even relief grants represents preferable alternatives.

A last difficulty of administrative rate-setting is the practical problem of keeping lenders and buyers fully informed of the various rates, and it is a problem which increases more than *pari passu* with the number of rates. Perhaps all the points raised above account for the guarded approval given by the Russell Sage Foundation and its spokesman, Mr. Nugent, to recent experiments of three states with administratively set rates.⁷⁰ It may be recalled that early writers were impressed with the need of a supervisory body as a means of putting teeth in consumer-loan legislation rather than of supplementing (superseding?) competition.

The writer believes that a two-rate structure is not dangerous in itself but only as a step in the wrong direction. Now that it has been actively promoted for some ten years, more harm might result in returning to a one-rate structure than in keeping it intact. Two rates, fortunately, are almost as easy to remember as one; the lower rate, $2\frac{1}{2}$ per cent a month on loans over one hundred dollars, is sufficient to attract capital and to prevent revival of community fanaticism in favor of a 6 per cent a year rate; and administrative discretion with respect to rate-setting is absent. The Russell Sage Foundation believes that the change is "designed to implement and not to dispense with competitive forces as the ultimate means of rate control."⁷¹ The writer is not convinced of the correctness of this statement, although he agrees with its adherence to competitive rate-setting. Because of the dominant

⁶⁹ See the statement in Ralph Young, *Personal Finance Companies and Their Credit Practices* (New York: National Bureau of Economic Research, 1940), p. 133.

⁷⁰ *Op. cit.*, p. 210.

⁷¹ *Ibid.*, p. 209.

position which the Foundation holds, the hope may be expressed that it does not succumb to the lure of administrative rate-setting.

The case against administrative discretion in determining the number of loan offices rests on similar grounds and may be dismissed more briefly. The ideal under any system is to encourage that number of optimum-size firms which will adequately meet the demand. The amount demanded (including, of course, the various loan sizes and risks) and the costs of lending are mutually determined in the market. The criteria to guide an administrative agency in correctly perpetuating this mutuality are nebulous. If it restricts the number of loan offices, as the large chain lenders now advocate,⁷² and at the same time lowers rates, true, costs will fall—but so will the number of borrowers able to get loan facilities. If loan offices were difficult to open, the demand would remain unsatisfied. However, the bulk of the assets employed are liquid, and illegal lenders could and would easily spring up to take care of it.

Mr. Nugent, in advocating agency limitation, is at pains to show that its extreme—monopoly—would be unworkable. His reason, essentially similar to that above, is that the business is selective, and that if borrowers are not satisfied at one place other facilities will readily be forthcoming.⁷³ But he also believes that competition will be more effective among a few lenders than among many. This runs counter to the well-known fact that the fewer the competitors, the more reluctant will any one of them be to initiate price reductions. On practical grounds it is wise to restrict unduly small-scale lend-

ing by a mechanical rule which stipulates a minimum capital per loan office. Beyond that lies the return of illegal lenders unless, as is not likely, the administrative body voluntarily licenses all who apply.

The positive case for competition within a flat-rate structure.—A positive case of some merit can be made in favor of competition under a flat-rate structure. Except for Professor Yntema, those who have studied the problem believe that the elasticity of demand for a given lender's loan service is high in the short run. Even he agrees that this is so in the long run. One writer says:

Some adjustments in rates have come about—more competitively than legislatively. . . . From the larger point of view of the uncertainties of the future, especially because of the possibilities of credit inflation with its promise of higher costs, it seems as if a going rate determined competitively under an adequate maximum would be more desirable and more flexible . . . than a low flat rate set rigidly by legislatures.⁷⁴

There is no doubt that competition to some extent takes the form of increased advertising campaigns instead of price reductions, but that is not peculiar to the lending business. The solution is a limitation of advertising rather than greater state supervision of rates. The fact that there has not been a greater reduction of aggregate rates is due not only to advertising but to the subsidization policy already noted.

BANKS AND COMPETITION

The positive case for competition within a flat-rate structure continued.—Several developments of recent years point to more effective competition in the future. Since they transcend the personal-finance

⁷² M. R. Neifeld, "What Consumer Credit Is," *Annals*, CXCVI (March, 1938), 72, and Blackburn, "Small Loan Business," p. 26.

⁷³ *Op. cit.*, p. 210.

⁷⁴ M. R. Neifeld, "Competitive Consumer Credit Developments," *Personal Finance News*, XX (October, 1935), 20.

field, a brief digression on the history of other cash agencies is necessary as a background. The two main ones are industrial and commercial banks. The former entered the field in 1910, the latter on a small scale in the 1920's and in larger measure since 1934.⁷⁵ Both operate under the usury laws but break them in spirit by using a discount method of charge. Because their real maximum rate does not go over 20 per cent a year, they compete with personal loan companies only for restricted loan classifications. In recent years this competition has become keener according to the studies completed in 1942 by members of the staff of the National Bureau of Economic Research. It will become more keen if the trend toward special legislation for banks, first apparent in 1936, continues. In that year industrial bankers drew up a uniform law providing for a maximum rate of 8 per cent a year on a discounted basis plus extra charges to cover investigation costs. A year later a similar bill, the Personal Instalment Loan Statute, was drawn up for commercial banks by the American Bankers Association.

The higher rates in these bills, actually about equal to those of the Uniform Small Loan Law, will broaden the common ground between banks and personal finance companies. Vitally needed now is a requirement that banks use the simple percentage method of rate statement (the method of the Uniform Small Loan Law) as a means of facilitating borrower shopping among agencies. Conditions are much more propitious for such shopping than they were before 1920. The long uphill fight of the business to gain

respectability has made borrowers less ashamed of borrowing and more independent. The entrance of commercial banks into the field has been of great psychological importance in this fight, representing as they do the paragons of financial respectability. Further, although some loans are of the emergency type, a growing percentage are of the anticipated variety—constructive loans, so called. As the recent invasion of the instalment-sales credit field by cash agencies gains momentum and as the principle of social security spreads, this tendency will be further accentuated. It is with anticipated credit that competition has the greatest chances of being effective.

The importance of access to capital as a means of reducing rates has long been appreciated. In 1931 one writer asked for a law "creating an entirely new type of banking institution, one that would be authorized to accept deposits and to make loans on endorsed notes, salaries, chattels, and pawns at rates which would make it possible to furnish credit facilities to the masses on reasonable terms."⁷⁶ Bank invasion of the consumer-loan field automatically realizes this proposal. There seems to be no reason for not extending the deposit privilege to all consumer-credit agencies.

A more difficult point arises. Banks create, as well as accept, deposits and thereby further reduce the cost of acquiring capital. Since the major components of consumer-lending costs are investigation and collection expenses and risk, the net advantage is probably negligible.⁷⁷ This is fortunate, for other agencies could not enjoy deposit-expansion facilities

⁷⁵ Industrial banks have been identifying themselves so closely with commercial banks in the last few years that separate discussion is unnecessary here (see Gilbert Harold, "Industrial Banks," *Annals*, CXCVI [March, 1938], 148).

⁷⁶ Louis N. Robinson, "The Morris Plan," *American Economic Review*, XXI (June, 1931), 233.

⁷⁷ Cf. C. O. Hardy (ed.), *Consumer Credit and Its Uses* (New York: Prentice-Hall, Inc., 1938), pp. 98-99.

merely by being given deposit privileges; they must also be empowered to accept checks. Professor George Filipetti apparently has the latter in mind, for he says: "The immediate reaction to this will be to set up the cry of credit inflation and over-consumption, but similar cries have been set up at other times and under other circumstances, only to have proved later that the fear was unfounded."⁷⁸ Credit inflation could not come about unless checking privileges were added to those of accepting deposits. The difficulty resides in the fact that, to get the former, noncommercial bank agencies would have to become full-fledged commercial banks. Many of them might not wish to do so. Further, state and federal authorities might raise objections. The writer's recommendation is the negative one of doing nothing. If deposit expansion is sufficiently important to dislodge agencies without it from the field, then banks will in time dominate consumer lending as they now dominate producer lending. Some bankers have predicted that this will take place. The other agencies, like the remedial societies, can then look back to the time when they performed a needed service.

Incidentally, some writers allege that banks are able to make lower charges because they do not allocate overhead to their consumer loans. In the absence of adequate cost data the issue must remain undecided. The writer cannot resist noting that this in bald form is one of the marginal versus average cost problems which would plague an administrative rate-setting body. The prohibition of branch banking in most states and the presence of chain lending in the small-loan field is an offsetting factor of some importance in favor of the latter.

⁷⁸ "Consumer Credit the Hope (?) of the Producer," *Management Review*, XVIII (March, 1929), 80.

CONCLUSION

In conclusion, then, a flat or, at the most, a two-rate, maximum-rate structure has strong points in its favor. The community can be educated into a religious belief in its necessity, thus providing the greatest assurance against the return of illegal lenders and all that they connote. It insures an adequate flow of capital into the field, without which competition is not possible. Within the infinite number of combinations of loan size and risk grade set by the maximum rate it puts the problem of selection on the shoulders of those who alone are capable of handling it—namely, the lenders. This is true whether or not cost data are available, a fortiori in the latter event. Although competition may not adjust rates precisely in line with the costs (marginal or average?) of making various loan combinations, what evidence is available suggests that it is much preferable to the alternatives of government lending or a rate structure administratively set.

The time of regarding cash lending as a stratified market is past. To implement the competition which has been growing in spite of legal variations among agencies it is necessary that they be swept away. Uniform maximum rates, uniform rate statement, and, less essential but still desirable, uniform maximum limits on loan size are important steps in this direction. A serious bar here is the fact that each agency is trying to retain its own share of the market by opposing such reforms or by pushing those designed to perpetuate the status quo.⁷⁹

⁷⁹ See, for example, an untitled address by Ralph Pitman, *United States Investor*, XLVIII (October 2, 1937), 1516. It is further evidenced by the opposition of New York State bankers to the simple percentage method incorporated in the New York Personal Loan Statute (Henrietta Cooper Jennings, *The Consumer in Consumer Banking* [New York: Consumer Credit Institute of America, Inc., 1939], pp. 49-50).

It may be alleged that the writer has gone so far in the direction of *laissez faire* that the last step of removing the maximum may as well be taken. The long-intrenched tradition of a maximum rate in the cash-lending field warrants its retention. It, coupled with licensing and state supervision to prevent flagrant abuses, represents desirable public policy toward the problem of regulating cash-lending agencies and their rate practices.

B. REGULATION OF INSTALMENT-SALES CREDIT

Because of its association with buying and selling and because of the *laissez faire* tradition in the United States, sales credit has long been held exempt from state control. Since open-account sales credit has been remarkably free of abuses and since it has never carried a separate price, there has been no occasion to suggest any rate reforms with respect to it.

THE CASE FOR A LAISSEZ FAIRE POLICY

The majority of writers on instalment-sales credit have taken the desirability of a *laissez faire* policy more or less for granted. The main difference between those writing before and after, roughly, 1930 is that the latter have been put on the defensive by the growing insistence in certain quarters on the need for regulation. Seligman, one of the best representatives of the pre-1930 group, gives the usual arguments for competition as a price regulator and then notes that for instalment selling "the problem is somewhat more complicated."⁸⁰ The complexity arises over misunderstanding of the true nature of the finance charge and over the failure of many instalment finance companies to state clearly what

their charges are. He admits that unclear methods of rate statement are undesirable since they prevent consumers from knowing, let alone comparing, rates among sellers; further, he infers that they reduce the effectiveness of competition as a price regulator. Since a clear statement of charges must be cast in percentage form, he emphasizes the possibility of misconstruing it as an interest rate and using it as the basis for unwarranted comparisons. The discount and lump-sum methods of stating the finance charge predominated as of the time he wrote (1927). Under the discount method the charge is stated as a percentage of the cash price less the down payment. The lump-sum method refers to its statement in dollars. The former, he notes correctly, is definitely misleading not only because it does not permit buyers to compare rates of different sellers but also because finance companies in using it "have frequently left the impression that the finance rates are comparable with bank interest."⁸¹ This is invidious, since whereas pure interest comprises the bulk of the bank interest rate it "constitutes only a part of the total cost of financing instalment sales."⁸² The other and larger part includes insurance, expenses of investigation and collection, and the risk of loss. He adds that the same persons do not, as a rule, have an alternative choice between borrowing from a bank, on the one hand, or from an instalment finance company, on the other. In other words, Seligman is anxious to make the point that a desire for rates clearly stated should not blind one to the fact that they will be higher than bank rates and are not to be compared with the latter.

He gives the lump-sum method guarded approval. It is more essential than the

⁸⁰ Edwin R. A. Seligman, *Economics of Instalment Selling* (New York: Harper & Bros., 1927), I, 284. Subsequent citations refer to Vol. I.

⁸¹ *Ibid.*, p. 285.

⁸² *Ibid.*

discount method since it permits the "average purchaser to come to a conclusion as to whether the costs outweigh the advantages."⁸³ This leads one into the realm of psychic costs, which, by way of *obiter dictum*, are explicitly stated to be more important than money costs. The writer has shown elsewhere that increased psychic satisfaction is the major justification of consumers' use of credit.⁸⁴ This is achieved by a comparison of alternative patterns of expenditure; the exertions of consumers in earning an income have little relevance. To this may be added another point. Consumers are interested in knowing the charges of different credit grantors so that once having decided to borrow they can make the best bargain. For such a purpose money cost stated on a comparable basis is the only solution. In fact Seligman recognizes this, for he concludes: "It is accordingly much to be desired that the stated finance charges should in every case be reduced to an actual correct percentage."⁸⁵ It is difficult to see why he should have raised the real-cost issue at all.

Returning to cash lending for the moment, one writer expresses the view that money costs alone should not be used in comparing loans of different agencies. He would include opportunity and sacrifice costs. Only the latter need concern us here; it is defined as "a cost which is not paid as money."⁸⁶ Comaker loans, predominant among industrial bankers, tend to bear a lower interest charge than the chattel loans which are characteristically made by personal finance compa-

nies. On the basis of a questionnaire he estimates the sacrifice cost of comaker over chattel loans to be as follows: (1) delay—\$3.47, (2) loss of privacy—\$7.87, (3) danger of loss of friendship of comaker—\$7.38, and (4) loss of independent credit—\$8.80. Expressing this sacrifice cost of \$27.52 in percentage terms and adding it to an interest charge of 17.3 per cent gives 37.137 per cent as the true cost of comaker loans. The impossibility of reducing real costs to money terms and the invalidity of adding money and real costs are the more obvious criticisms of such an approach. Further comment seems unnecessary.

Seligman believes that the lack of clearness in stating rates and the attendant temptation to overcharge have been due fundamentally to the excess competition which has characterized the instalment-sales field in the past. And, curiously enough, "competition, which has in no slight measure engendered the abuse [overcharging], is setting in motion forces which are likely to cure the abuse."⁸⁷ This is presumably based on the conviction that the growth of instalment selling has been too recent for competition to become a stabilizing force. As the weaker companies are weeded out (he says this is now [1927] taking place) the remaining companies, those incidentally who "are succeeding precisely because they are giving better service at lower rates,"⁸⁸ will through competition lower rates. In this connection he believes that while the novelty of instalment selling has no doubt permitted or even encouraged the concealment of finance charges, longer experiment with the plan and the endeavors of the larger finance companies to make known the exact costs of finance will probably result in the education of the consumer. . . . Our conclusion would

⁸³ *Ibid.*, p. 293.

⁸⁴ *Op. cit.*, chap. iv.

⁸⁵ *Economics of Instalment Selling*, p. 293.

⁸⁶ Franklin W. Ryan, "Sacrifice Cost of Personal Loans," *Personal Finance News*, XV (January, 1931), 7.

⁸⁷ *Economics of Instalment Selling*, p. 294.

⁸⁸ *Ibid.*, p. 293.

therefore be that while there are still undoubtedly abuses in the finance charges, the situation is beginning to remedy itself.⁸⁹ . . .

RATE-STATEMENT REFORM

Evans Clark presents one of the first examples of what since has become the predominant position of those advocating price regulation. First, he is at some pains to deny that substantial inequality of bargaining power exists between buyer and seller. More precisely, he makes it clear that he does not believe that any inequality stems from defects inherent in the borrower, e.g., "the credit extended to buyers on the instalment plan has little of the necessitous character of the usual small loan credit."⁹⁰ Then later, after advocating maximum-rate regulation of small loan companies, he adds:

The arguments for such strict regulation of instalment finance companies are not so compelling because of the diminished pressure of necessity upon those who want this kind of credit and the larger number of agencies at which to trade. A good case can be made out, however, for an enforced accounting to state authorities, even though the regulation of their rates would be more difficult to justify.⁹¹

He unequivocally advocates legislation by which all instalment agencies should

be required to calculate their rates on the basis of a single standard of measurement, which would show the percentage per year rate charged the borrower for the funds of which he has the actual use, and to include a statement of this rate in all their loan contracts.⁹²

By enabling borrowers to make intelligent comparisons among sellers and finance companies price competition would

be stimulated. He does not share the confidence of Seligman and others that competition will of itself dictate clear rate statement. Another writer notes that "five years have elapsed since this statement [of Seligman] appeared, but the endeavors of finance companies to make known their charges have not yet been observed."⁹³ As late as December 8, 1939, the Federal Trade Commission ordered automobile finance companies to stop advertising the use of a discount method of rate statement on the grounds that it was misleading.

W. T. Foster argues that, unlike the cash-lending field, conditions are so diverse in instalment selling that no one maximum rate could well be applied unless it were so high as to be meaningless.⁹⁴ By default, clear rate statement becomes the desired reform. This reasoning is not valid. The two main cost variables are loan size and risk, and they are no less diverse in cash lending than in the extension of sales credit. The implementing-of-competition argument (Mr. Foster uses it as well as the other) is sufficient in itself to warrant clear rate statement.⁹⁵

Main opposition has come from the instalment-sales credit business and is directed as much at the method of rate statement suggested as it is at the idea

⁹³ Lewis Froman, "Cost of Instalment Selling," *Harvard Business Review*, XI (January, 1933), 227. For an earlier example of skepticism see N. R. Danielian, "Theory of Consumers' Credit," *American Economic Review*, XIX (September, 1929), 395.

⁹⁴ "Public Supervision of Consumer Credit," *Journal of the American Statistical Association*, XXXIII (March, 1938), 79.

⁹⁵ Unfortunately the exhaustive statistical study, *Sales Finance Companies and Their Credit Practices*, conducted by the National Bureau of Economic Research and written by Wilbur Plummer and Ralph Young, comes to no conclusions on the subject. The general reaction after reading this and the other consumer instalment-finance studies of the Bureau is that all controversial material has been deleted.

⁸⁹ *Ibid.*, p. 294. For a long list of other writers holding to a similar position see Mors, *op. cit.*, chap. vii.

⁹⁰ *Financing the Consumer* (New York: Harper & Bros., 1930), p. 227.

⁹¹ *Ibid.*, p. 235.

⁹² *Ibid.*, p. 243. This passage he italicizes.

as such. Needless to say, the method should be uniform throughout the whole consumer-credit field. The only unambiguous way is in the form of a simple percentage, usually monthly, rate on the unpaid balance. To paraphrase the Consumer's Advisory Board, the reasons for this are as follows: (1) Sellers on deferred-payment plan perform two distinct functions—selling and credit granting. (2) If there is a charge for the latter, then, like the price of merchandise, it should be stated in a manner which makes it readily comparable with all prices for the use of money repayable in periodical instalments. (3) The only accurate method of price statement is in the form of a given percentage on a given principal for a given time period. Any other method permits the manipulation of one of the two variables—principal and time. (4) Since the outstanding amount of an instalment debt declines monthly, the only unambiguous method of rate statement is in terms of a given percentage on the current unpaid monthly balance.

From a theoretical point of view the writer believes that these propositions are incontrovertible and provide sufficient answer to the claim that the important figure to the consumer is the finance charge expressed as a percentage of the cash price.⁹⁶ Anyone acquainted with compound-interest formulas should be able to convince himself of this in short order. Further, it seems self-evident that competition cannot function properly unless buyers know what they are being charged. Knowledge of the market is one of the assumptions underlying theoretical economic analysis. An outright denial of the necessity and/or desirability of such knowledge is one of the two major

arguments advanced by opponents of reform. As one writer puts it:

The idea is that this statement of equivalent interest rate would enable purchasers to shop around more intelligently among instalment sellers to obtain the most advantageous finance charge. I believe that this would be of no advantage to the purchaser. He is interested in the total price in dollars and the amount in dollars of his monthly payments, but he is not interested in the interest rate.⁹⁷

Since none of the writers holding this position provides reasons therefor, it is necessary to supply the deficiency. Several possibilities are worth mention. It might be argued that the finance charge is so small relative to the price of the article being purchased that the consumer is indifferent to variations in it. In other words, relatively large variations in the finance charge cause only slight variations in the gross instalment price and hence give the consumer little concern.⁹⁸ This is irrelevant since the real comparison is between the instalment charges of different credit grantors. Second, buyers may be too ignorant to shop around even if they were given sufficient information for so doing. However, it would be unfair to read this interpretation into the statements of men who believe in competition as a regulative force.

In the third place, perhaps a simple percentage rate does not give buyers the type of information they consider essential. Mr. Ayres seems to have this in mind in his allegation that it is the price in dollars which is of importance.⁹⁹ Assuming intelligence on the part of the

⁹⁷ Milan V. Ayres, "Suggestions for a Uniform Instalment Sales Law," *Time Sales Financing*, IV (June, 1939), 5.

⁹⁸ For the behavior of the gross-time price as finance charges vary see Plummer and Young, *op. cit.*, p. 219.

⁹⁹ "Suggestions for a Uniform Instalment Sales Law," p. 5.

⁹⁶ Milan V. Ayres, "Facts and Fallacies on Instalments," *Personal Finance News*, XXIII (April, 1937), 11.

buyer, he can be interested in the dollar cost as such for only two reasons. The first would lie in giving him the means of choosing the seller who advances credit on the lowest terms. It is presumed that he chooses among sellers who have a similar quality of merchandise and who quote cash prices unambiguously. Since sellers extend credit for different periods and require varying size down payments, the buyer can determine the low-price seller only by reducing the charges of all of them to a common denominator. But the only common denominator is a rate on a given principal for a given time. Whether one calls the result an interest rate or not is immaterial, although usage dictates the former. The important point is that this is what the reformers have in mind in their demands for clear rate statement. At present many sellers and finance companies neither state rates plainly nor give sufficient information to permit their computation.¹⁰⁰

But intelligent buyers may consider dollar costs important for a second reason—namely, as a means of determining whether to buy or not to buy and, if so, whether to buy on cash or on time. This harks back to Seligman's argument that they are interested in a comparison of the real costs of instalment purchases with the advantages (psychic income) of such purchases. Whether money costs are the sole means of determining psychic income or only one among several, it seems clear that, other things equal, buyers would tend to maximize satisfaction by seeking the lowest dollar costs. But the latter must be interpreted not in an absolute sense but relative to the value of the services to be received—in this case the amount of credit extended. This can be done only by reducing the dollar charges to a comparable basis, namely,

by converting them to a rate on a given principal for a given time period. Lacking this, "price competition is ineffective . . . and the consumer is utterly unable to measure the price he pays for instalment credit in terms of the advantages of saving and buying for cash, of using such cash resources as may be available to him, or of finding cheaper credit facilities elsewhere."¹⁰¹ The writer wishes to repeat that incursions into the realm of psychic income have been both unnecessary and unfortunate in discussions of price policy.

The second major objection to an interest form of rate statement is the argument that it implies that the whole charge is interest whereas actually such is not the case. Historical considerations give it a certain validity. When the charges for various types of credit are all expressed in interest-rate form, there is a danger that persons uninformed as to the reasons for the discrepancy between instalment credit and bank rates may come to the unwarranted conclusion that the former are too high and bring pressure to bear for rate-reduction statutes. The sections on consumer cash lending have indicated that public ignorance of the need for high rates was one of the obstacles to constructive legislation. It is true that the campaign waged since 1910 in that field has educated a great many persons and has probably paved the way for wider understanding of the need of high rates in instalment-sales credit. However, lack of understanding may still be sufficiently widespread to make immediate rate reform a dangerous experiment. For example, a Wisconsin committee, after advocating the eventual adoption of an interest type of rate state-

¹⁰¹ Rolf Nugent and Leon Henderson, "Instalment Selling and the Consumer: A Brief for Regulation," *Annals*, CLXXIII (May, 1934), 98.

¹⁰⁰ Froman, *op. cit.*, p. 230.

ment, suggested that its immediate introduction would work irreparable harm since the whole business of instalment selling has long been based on a flat-rate charge.¹⁰²

The possibility of misinterpretation by the courts is another danger. Mr. Ayres notes that through long years they have built up the doctrine that the difference between a time and a cash price is not interest and therefore does not come under the usury laws. "Nevertheless, the idea that such sales do involve usury is constantly cropping up, and quite frequently judges in the lower courts agree to the contention that usury is involved."¹⁰³ Assuming that legislation is inevitable, he believes that to be model it should contain a specific statement that a "finance charge is not to be considered interest."¹⁰⁴ This belief, coupled with his argument against a simple percentage method of rate statement, clearly implies that the finance charge should be divorced sharply from all connotation of interest. Should the courts reverse themselves, the results would obviously be calamitous not only to the instalment business but to the community as well, since instalment-sales credit cannot be advanced profitably at usury rates.

The dilemma arises: though logically justifiable, an interest form of rate statement seems to be inexpedient on historical grounds. For those impressed by the latter a compromise lies in the disclosure statutes already adopted in Indiana, Wisconsin, and Massachusetts. They require the seller to provide the buyer with all the information necessary to compute the cost of the credit in terms of in-

terest, i.e., cash price, down payment, original unpaid balance, insurance charge, finance charge, time balance, number of payments and amount of each, and a description of the insurance coverage. Mr. Ayres in 1939 approved these laws on the grounds that they would make it easier for instalment finance companies to combat bank and small loan company competition.¹⁰⁵

Admitting that such a compromise has merit, the writer believes that a stronger case can be made for legislation requiring an interest form of rate statement. To avoid legal difficulties it should exempt from the usury laws instalment-sales-credit granting. The public has been educated, in part at least, to the need of higher-than-usury rates by the Uniform Small Loan Law. A similar result is not impossible in sales credit; in fact it is going on at an increasing speed because of the growing competition of banks for instalment business.¹⁰⁶ This competition could be enhanced by requiring all consumer credit agencies to quote rates uniformly.

Finance companies have been responsible in some measure for encouraging the belief that instalment-sales credit costs but 6 per cent a year. For that they must be willing to run the risk of lost business when the public finds out otherwise. The drastic reduction of instalment selling during the present war offers a propitious time to clear up the rate-statement muddle. It is difficult to see the point that rate-statement legislation represents price-fixing and destroys the individual's control over his resources.

¹⁰² *Report of State Banking Commission and Interim Advisory Legislative Committee To Investigate Finance Companies* (Madison, Wis., 1935), p. 42.

¹⁰³ "Suggestions for a Uniform Instalment Sales Law," p. 4.

¹⁰⁴ *Ibid.*

¹⁰⁵ "A Suggested Uniform Sales Financing Company Act," p. 11. He also regards this type of law as a "substitute and preferable measure to be offered for adoption when bills for regulating finance companies are being advocated" (*ibid.*).

¹⁰⁶ Plummer and Young (*op. cit.*, pp. 285, 288) note the intensification of competition.

Distinctly minor in nature are several objections to such reform. One is the claim that it would make more work for instalment finance companies and so necessitate a rise in finance charges. A second, termed "the most serious objection," is the alleged lack of "general agreement as to the proper method of computing the interest rate."¹⁰⁷ According to this source, myriad proposals are extant, some so complicated as to be incapable of computation even with the aid of tables.

MAXIMUM-RATE CONTROL

There have been a few proposals for some form of maximum-rate control. Of an impractical nature is the suggestion that the functions of selling and credit granting be divorced.¹⁰⁸ This would, of course, automatically bring all lending under the usury or small-loan laws. A more direct approach starts with the claim that the rise of instalment selling "was accompanied by several conditions which completely changed the relative bargaining position of the parties to the credit agreement."¹⁰⁹ Of the three mentioned, the crucial one seems to center around the fact that the instalment transaction attracted—in fact, was designed to attract—customers of relatively low incomes. Because their commitments are high relative to their incomes, sellers required and began to use powerful credit instruments to cover their risk. Then comes the conclusion:

¹⁰⁷ Ayres, "Suggestions for a Uniform Instalment Sales Law," p. 5.

¹⁰⁸ Lawson Purdy, "Instalment Purchasing and Saving," *Proceedings of the Academy of Political Science in the City of New York*, XII (January, 1927), 110-11, and Neifeld, *The Personal Finance Business*, pp. 385-92.

¹⁰⁹ Nugent and Henderson, "Instalment Selling and the Consumer," p. 101.

The rise of instalment selling has opened wide gaps in this regulatory armor [the protection of consumers in the field of consumer credit] and exposed large groups of consumers to abusive practices. As in the small loan field, society will probably begin by restricting the use of certain collection instruments and end by finding complete supervision necessary. Until then the abuses of instalment selling will probably increase.¹¹⁰

Curiously enough, in spite of the growing advocacy of laws calling for a plain statement of rates, no states have enacted any; and whereas little pressure has been exerted for maximum-rate legislation two states have already set up such maximums.

Unfortunately there has not been so much discussion of the pros and cons of maximum-rate legislation as would seem desirable. Obviously, it is vastly different in nature from rate-statement legislation and must be debated on wholly different grounds. What opposition exists may be classified into those who would limit regulation to requiring plain rate statement and those who oppose any price regulation. Most of the former are somewhat guarded in their opposition, feeling either that rate-statement legislation should first be given a chance and/or that sufficient data are not now available to set maximums intelligently. Their position is one of expediency. This probably accounts in some measure for the intense opposition from those connected with the instalment finance business to any regulation. They may view rate-statement legislation merely as an opening wedge. But, unless the latter is tried, less desirable control may be forthcoming.¹¹¹

Mr. Ayres, in commenting on the In-

¹¹⁰ *Ibid.*, pp. 102-3.

¹¹¹ Dudley Cavers, "The Consumer's Stake in the Finance Code Controversy," *Law and Contemporary Problems*, II (April, 1935), 216.

diana act, says that it "has not proven particularly objectionable; nor . . . has it accomplished anything worth-while."¹¹² He claims that to be effective a rate-setting law must regulate both the cash and the time prices. This is unlikely since it "would be the extreme of price fixing."¹¹³ Admittedly there is a possibility that maximum-rate regulation may cause some sellers to include a part of the finance charge in the cash price. But, assuming that competition is at all effective, sellers who do so will find their sales shrinking and will be forced to lower their prices. Mr. Ayres's argument is thus applicable only in a system wherein competition is inoperative.

C. CONCLUSION ON CONSUMER CREDIT AS A WHOLE

A better case can be made for opposing rate control. These favoring rate-state-ment legislation have pointed out that buyers are not necessitous; and therefore, given an opportunity, competition should prove effective in reducing finance charges, particularly for such standardized items as automobiles, radios, refrigerators, vacuum cleaners, and washing machines. A similar conclusion holds for that part of cash credit (and it is growing) which falls in the anticipated category. However, the fact that in terms of origins cash lending was associated with necessity and the added fact of the long and deeply entrenched belief in legal maximums makes undesirable at the present time any attempt to eliminate them in that field. This will not preclude

effective competition between cash and sales lenders if all quote rates on a comparable basis inasmuch as they tap similar borrower strata.

Since price competition works best if other aspects of the contract are standardized, it would be desirable to secure legislation requiring standard contract forms and regulating the conditions under which repossessions may be made. Further antitrust laws could be used to prevent instalment-sales finance companies from making tying contracts with retailers whereby the latter automatically turn over all their business to them. Banks are now going straight to consumers in an effort to counteract this—a development which, incidentally, will make the latter more credit-price conscious.

With the stigma formerly attached to cash lending decreasing and with the sales-credit field as yet in a healthy condition it is still not too late for states to pass legislation designed to give competition a chance to work effectively throughout the consumer-credit field. This does not mean that competition can eliminate all abuses—a point which those with an itch for reform easily overlook. But abuses will be less than under the inevitable alternative of administrative control, the defects of which were pointed out in the discussion of cash lending and which apply to sales-credit extension as well. "Real danger is found . . . when the state attempts to supplant competition as a rate determinant or to anticipate by restrictive legislation, every possible danger to which a buyer of the credit commodity is subject."¹¹⁴

¹¹² Milan V. Ayres, "The Economic Function of the Sales Finance Company," *Journal of the American Statistical Association*, XXXIII (March, 1938), 68.

¹¹³ *Ibid.*

¹¹⁴ Leon Henderson, "State Regulation of the Small Loan Business," *Journal of Business*, IV (July, 1931), 225-26.

